

15th Edition

Tax Savvy for Small Business

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- Maximize your deductions
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TAX LAW
CHANGES

Frederick W. Daily, Tax Attorney
and author of *Stand Up to the IRS*





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15th Edition

Tax Savvy for Small Business

Attorney Frederick W. Daily



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We believe accurate, plain-English legal information should help you solve many of your own legal problems. But this text is not a substitute for personalized advice from a knowledgeable lawyer. If you want the help of a trained professional—and we'll always point out situations in which we think that's a good idea—consult an attorney licensed to practice in your state.

Dedication

To my wife, Brenda, who has brought me everything that is good in life.

Acknowledgments

Trying to translate the tax code into plain English for the small business owner was a challenge that all but overwhelmed me. Without the help of many others I could not have done it.

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Your Tax Saving Companion

“In America there are two tax systems; one for the informed and one for the uninformed. Both systems are legal.”

—Judge Learned Hand

If mastering the tax code were a prerequisite to starting a business, no one would dare. Luckily, the basics of federal taxes are right here in this book. And once you grasp the fundamentals, you can pick up the rest as you go along, perhaps with the help of a tax adviser. As the well-worn phrase goes, “It’s not brain surgery.”

This book is for the typical small business in the United States—one that takes in less than \$5 million and has fewer than 20 employees. Even if you sometimes need the help of a professional, this book will help you make informed tax decisions and put more money in your pocket at the end of the year.

You will learn:

- the best way to deduct business expenses and write off purchases
- the tax benefits of each business ownership structure: Should you choose a sole proprietorship, partnership, limited liability company, or corporation?
- what kinds of records to keep and how long to keep them
- the best ways to hire help, taxwise
- top fringe benefits for small businesses
- ways to legally minimize taxes and lower your odds of an audit, and

- what to do if the IRS ever challenges your business tax reporting or sends you a tax bill you don’t agree with.

Owning and operating a small business, full or part time, has been called the little guy’s tax shelter. The self-employed (like your author) get tax benefits for expenditures not allowed to “wage slaves.” In effect, you are sharing expenses (as well as profits) with Uncle Sam—and, in most cases, with your state as well.

This book explains, in plain English, how to take advantage of the many tax benefits available to small business owners. We will show you how:

- personal expenses can become partially deductible: your home, car, computer, meals, education, and entertainment
- retirement plans can shelter part of your venture’s income from taxes, accumulate earnings tax-deferred, and provide income for your golden years at a lower tax rate
- family members—young and old—can be put on the payroll to reduce a family’s overall tax bill, and
- travel and vacations can qualify in whole or in part as deductible business expenses.

Sound interesting? With all of these possibilities, your business can earn less than if

you were working for someone else, and you still can come out ahead. Of course, by going into business, you might be trading an eight-hour-a-day job for a 24-hour one. But for many of us, it is worth it.

We know you put your energy, resources, and money into getting your business venture started or keeping it running. Let us help by giving you the practical information you need to make the best tax choices and decisions.

Get Updates and More online

When there are important changes to the information in this book, we'll post updates online, on a page dedicated to this book: www.nolo.com/back-of-book/SAVVY15.html. You'll find other useful information there, too, including author blogs, podcasts, and videos.



Tax Basics

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Take it from one small business owner to another: Operating a business without tax savvy is like skydiving without a parachute—certain to end in calamity. Many business failures stem from ignoring the record keeping and taxes. Like it or not, the government is always your business partner.

Tax knowledge has powerful money-saving potential. It can give you a fatter bottom line than your competitors who don't bother to learn. For instance, there are several ways to write off car expenses. The right choice can mean a few thousand more after-tax dollars in your pocket each year.

Four Different Federal Taxes Affect Small Business Owners

- Income taxes (everyone who makes a profit owes these)
- Self-employment taxes (Social Security and Medicare taxes)
- Payroll taxes (if your business has employees)
- Excise taxes (only a few small businesses are subject to these).

Thousands of federal tax laws, regulations, and court decisions deal with these four categories. We will look only at the relatively few rules most likely to affect you.



TIP

Small business or independent contractor?

Self-employed people often ask whether they are a “business.” The IRS says “yes.” Whether you run a flower shop or work at home as a website designer, you’re a small business. This includes all kinds of self-employed people, from independent contractors, consultants, and freelancers, to the guy who owns the pizza parlor down the street.



RESOURCE

The IRS does not require or issue business licenses. Whether you need any kind of license depends on your state and local authorities. For small business start-up issues, see *The Small Business Start-Up Kit*, by Peri Pakroo (Nolo).

How Tax Law Is Made and Administered: The Short Course

Think of this section as a high school government lesson, only try to stay awake this time—it could mean money in your pocket.

The federal government. Visualize a three-branched tree. Congress, the legislative branch of the federal government, makes the tax law. The executive branch, which includes the Treasury Department, administers the tax law through the IRS. The judicial branch comprises all the federal courts, which interpret the tax laws and overrule the IRS when it goes beyond the law.

The power to tax incomes was granted by the 16th Amendment to the U.S. Constitution; the first Income Tax Act was passed in 1913. Contrary to what fringe groups and con artists contend, income tax law and the IRS are legal and are not going away.

The code. Tax law begins with the Internal Revenue Code (referred to throughout this book as the tax code or IRC). Congress enacts and revises the tax code. The president signs it (usually), and it becomes law. One major reworking of the IRC was officially called the Tax Reform Act, but was known to tax pros as the Accountants’ and Tax Attorneys’ Relief Act. The tax code is now over 8,500 pages of exceedingly fine print.

The IRS. The Internal Revenue Service (IRS) is a division of the Treasury Department. It is headed up by the Commissioner of Internal Revenue, a

presidential appointee. The IRS is charged with enforcing the tax code.

The IRS is headquartered in Washington, but it is doubtful you will ever deal directly with anyone there. The real work is done at IRS satellite offices.

The courts. The United States Tax Court interprets the tax laws and decides disputes between the IRS and taxpayers and interprets the tax code. It is pretty easy to go to tax court in most cases, even without an attorney. Tax disputes are also decided in U.S. District Courts and the Federal Court of Claims, but these require payment of the disputed tax first, unlike in the tax court. All decisions in those courts, for or against you, may be reviewed by higher courts, meaning the various U.S. Courts of Appeal and the U.S. Supreme Court. The exception is small case tax court decisions; see Chapter 21 for details.

See, that wasn't all that bad, was it? Now, venture forth into the rest of the book and may the small business gods be with you.



CAUTION

Tax laws are ever-changing. While we try our best to keep this book up to date, Congress is forever tinkering with the tax code. Some changes are made retroactive, others become law on the date they are signed by the president, and some won't be effective until the next year or further into the future. Also, federal court decisions, which interpret the tax code, are released throughout the year and may change what is written here. Your best strategy is to make sure you have the most current edition of this book (check Nolo's website for updates to this book), and check with your tax adviser to see if anything has changed in your tax world.

Where to Find Tax Rules

How to research tax law questions is covered later in this book. Here's a brief description of the main sources of federal tax law.

Federal statutes. Congress enacts tax laws, called codes, which make up the Internal Revenue Code. Each tax provision (called a "code section") has its own number and title. For example, IRC § 183 refers to tax code Section 183, titled "Activities Not Engaged in for Profit."

IRS publications. When Congress makes tax laws, it paints with a fairly broad brush. It's then up to the Treasury Department (the IRS is a part of it) to determine how the tax code is to be applied. The details are filled in by IRS publications, such as Treasury Regulations. These "regs" are numbered in the same order as their related tax code sections, but preceded by the numeral "1." For example, the regulation explaining IRC § 183 is Reg. 1.183. (Not all IRC sections have corresponding regulations.)

Both the IRC and IRS publications are available at most public libraries, larger bookstores, and, of course, IRS offices. The IRC is online at the IRS website (www.irs.gov) and www.law.cornell.edu (search for U.S. Code, title 26, Internal Revenue Code). IRS regulations are available on the IRS's website.

Court cases. When the IRS and taxpayers go to court, a federal judge can reject the IRS interpretation of the tax law. The judges' published opinions offer guidance on the correct interpretation of the tax code. Look up tax court opinions (from January 1, 1999 to the present) on the tax court's website at www.ustaxcourt.gov or at a law library, courthouse, or law school.

Marginal Tax Rate and Tax Brackets

In our income tax system, the more money you make, the higher your tax rate. Often referred to as your ordinary income, or marginal tax rate, it is the percentage at which the last dollar of income you earn will be taxed. You can find your tax rate in the annual federal income tax bracket tables published each year by the IRS. See www.irs.gov.

Don't Forget About State and Local Taxes

While this book covers federal taxes, you and your business may also be taxed by your state and local agencies. Unfortunately, it can be even more time-consuming to comply with state tax laws than with federal tax laws, especially if your enterprise is a multistate affair.

State tax enforcement agencies are often more frustrating to deal with than the IRS. (For advice on dealing with state tax agencies see *Stand Up to the IRS*, by Frederick W. Daily (Nolo).) And many states have out-of-state enforcement offices or use private collection agencies to track you down anywhere in the United States. So, just because you live in Maryland, don't think the tax hawks from California can't get you.

Here are some state tax issues to watch out for:

- **Income taxes.** Most states (41) have personal income taxes. Florida, Nevada, and Texas are the most notable exceptions.
- **Sales taxes.** Most states have a sales tax on things sold within their borders. But each state has different rules for collection and exemptions.
- **Use taxes.** Most states tax things purchased out of state that were shipped into your state without paying sales tax.
- **Business transfer taxes.** Whenever a business changes hands, your state, county, or city may impose a tax on the buyer, the seller, or both. (See "State and Local Transfer Taxes" in Chapter 17.)
- **Inventory and other property taxes.** Some states and local governments impose an annual tax on personal property used in the business, such as vehicles or equipment. And, most counties tax real estate, whether it is used for business or personal purposes.
- **Internet taxes.** There is a federal moratorium on states' imposing taxes on Internet transactions unless the seller has a physical presence in the state. However, some states impose a "use" tax for out-of-state purchases (see above), and Internet sales are taxed if the goods are delivered within your home state.
- **Payroll taxes.** All states with income taxes have a payroll tax, withholding, and collection system similar to the federal system.
- **Telecommuter taxes.** New York is one of a growing number of states that tax you if you work from home in another state (for instance, Connecticut), if the main business location is in New York.
- **License fees.** There are myriad state and local licenses that a business must secure. Check with your local government agencies, chamber of commerce, or attorney.
- **Out-of-state taxes.** As an employer, you can be responsible for withholding state income taxes on your out-of-state employees' income for their home states.
- **Estate taxes.** Most states impose an estate tax on the value of all of your assets, including your business, when the estate is large enough. (See "Preserving a Family Business After Death" in Chapter 13.) This tax is in addition to the federal estate tax discussed later in the book.
- **State and local agencies.** To find your state tax and licensing agencies, go to www.statelocalgov.net or www.taxadmin.org for a listing of all the government agencies in your state, or look them up in your local phone book. Also, most states and many cities and counties have their own websites.

For example, Janice is single, lives in New York, and reports \$100,000 in income. Her marginal tax rate, or tax bracket, is 28%. Janice's income tax is figured like this: The first \$83,600 of income will be taxed in increments at the 10%, 15%, and 25% tax rates, and the remaining \$16,400 will be taxed at 28%. Every additional dollar Janice earns will be taxed at 28% until it reaches more than \$174,400 in income, at which point her marginal tax rate, or tax bracket, will jump up to 33%, and maybe then to 35%.

If Janice factors in New York state and local income taxes and Social Security and Medicare tax, her true marginal tax rate may exceed 50%. Some types of income are taxed at different, lower rates, called capital gains. However, capital gains rates typically apply only to investors, not small businesses and their owners.

**TIP**

What's your marginal tax rate? Determine the effect of additional business income or deductions by applying your marginal tax rate. For instance, if your marginal tax rate is 28%, 28¢ of every new dollar you earn goes to Uncle Sam. Conversely, you save 28¢ in federal income taxes on every additional dollar that qualifies as a deductible expense. Knowing your marginal tax rate can tell you how much you will be saving by increasing your tax deductions in any given year.

A Word About Tax Shelters

A so-called tax shelter can be a perfectly legal way for a small business to reduce its income tax bill. One of the more common forms of tax shelters is to own rental property where the costs of owning the property (mortgage payments, interest, insurance) exceed the rental income. The owner/taxpayer can use the loss from the rental property to offset income from other sources on his or her tax return.

2011 Federal Personal Income Tax Brackets*

Tax Bracket	Income If Single	Income If Married Filing Jointly**
10%	\$0 – \$8,500	\$0 – \$17,000
15%	\$8,500 – \$34,500	\$17,000 – \$69,000
25%	\$34,500 – \$83,600	\$69,000 – \$139,350
28%	\$83,600 – \$174,400	\$139,350 – \$212,300
33%	\$174,400 – \$379,150	\$212,300 – \$379,150
35%	\$379,150 +	\$379,150+

* These dollar amounts are subject to annual IRS adjustments for inflation.

** Tax brackets for heads of households and married people filing separately are somewhat different.

This table does not take into account itemized or standard deductions and personal exemptions that all taxpayers get for themselves and their dependents. For 2011, the standard deduction is \$5,800 (single) and \$11,600 (married filing jointly).

This should not be confused, however, with the type of abusive tax shelters that the IRS is on the watch for. These deals, often marketed by self-styled financial experts or even some big named accounting firms, involve transactions with tax reduction motives but minimal or no economic substance. They usually promise large tax deductions or write-offs beyond your investment cost—the tax equivalent of a free lunch. If you are audited, the IRS will demand that the proposal could stand on its own as a money-maker, without the tax benefits.

The moral is, don't buy into a tax savings scheme, whatever it is called, unless it has a reasonably good chance of making a profit—with tax savings as an added bonus. Many of these plans are so complicated that no one wants to admit they

don't understand them. If the promoter harps on the tax savings first, watch out. Don't plunge in without checking with a trusted tax pro. If you get involved in a scheme that the IRS rules is abusive, you've got to give back any tax breaks, and pay penalties, interest, and any legal fees.

The Alternative Minimum Tax (AMT)

As if the tax code isn't diabolical enough, there is something called the alternative minimum tax (AMT). The AMT is not a business tax but is really a second (alternative) set of tax rates that potentially can affect anyone with income of more than \$48,450 (single) or \$74,450 (married) (2011). The theory of the AMT is that people who take a lot of tax deductions or tax credits should still have to pay a minimum amount of income taxes.

All taxpayers must figure their income tax under both the regular (marginal) tax rates, and the AMT rates—and pay whichever is the *greater* number. Ouch! Fortunately, all income tax software automatically figures the tax both ways. The AMT is reported on Form 6251, and filed with your individual tax return.

The AMT effectively denies people many tax deductions and credits otherwise allowed on their tax returns. AMT is figured by adding back to taxpayers' income many of the exemptions, deductions, and credits that lowered their taxable income in the regular system. The AMT is triggered by such things as:

- net operating loss deductions in a business
- interest deductions on home equity loans
- large itemized deductions for state and local taxes

- foreign tax credit
- passive income or loss
- certain installment sale income
- unreimbursed employee expenses
- exemptions for dependents
- child and education tax credits for Hope scholarships and Lifetime Learning
- interest income on certain tax-exempt bonds, and
- the exercise of incentive stock options.

The AMT is yet another reason to take every tax break possible and use the help of a tax pro and software programs like *TurboTax* (Intuit) or *Quicken*.



TIP

Don't understand tax terms? Check out the glossary at the back of this book for a plain-English explanation of the taxes used in this book.

Do You Need a Tax Professional?

This is not a tax preparation manual. Our goal is to explain the rules in plain English so you will know how they apply to your business and how to benefit from the tax laws.

As good as we hope this book is, nothing takes the place of a personal tax adviser, particularly if you're in business. Everyone's tax situation is unique, and tax laws change annually. But the more you know, the better you can work with your tax adviser (referred to as a "tax pro" throughout this book), and the less you will have to pay for the service. (See Chapter 23 for tips on finding and using a tax pro.)

Deductible Business Expenses

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“There is nothing sinister in arranging one’s affairs as to keep taxes as low as possible ... for nobody owes any public duty to pay more than the law demands.”

—Judge Learned Hand

Small business owners and self-employed people are always looking for ways to maximize their tax savings. The key to legally cutting your business taxes to the bone is knowing the best ways to deduct business operating expenses to produce the very lowest taxable income. That’s the focus of this chapter. In Chapter 3, we’ll complete the picture with the rules for writing off assets purchased for your business.

First, how is your business income taxed? The U.S. government taxes a business’s profits—so the more you end up with after deducting your expenses, the more taxes. And, ours is a progressive tax, meaning the more you make, the higher percentage of income tax you pay.

So, the American entrepreneur has a strong incentive to keep taxable profits as low as possible, while at the same time taking home as much money as possible.

Let’s start with a simple illustration of how net taxable profits are determined in any kind of business operation.

EXAMPLE: Homer quits his job at a nuclear power plant and goes into business for himself making and selling an automated dog walker that he invented. Incredibly, Homer makes money, and at the end of the year determines his taxable profits as follows:

Gross sales	\$ 35,000
Less cost of goods sold (manufacturing costs)	– 12,000
Gross profit (before operating expenses)	23,000
Less deductible operating expenses (shipping, supplies, rent, utilities, etc.)	– 5,000
Net profit (taxable to Homer)	= \$ 18,000

How much Homer will owe in federal (and maybe state) income and self-employment (Social Security and Medicare) taxes on the \$18,000 net profit depends on his family’s total income, personal deductions, and exemptions.



RELATED TOPIC

Wondering what you must include in your business’s income? Sales only? Bartered goods? Foreign income? Gifts? Ill-gotten gains? Fringe benefits? Inheritances? To learn exactly what you must include in your sales and income figures, see “What Is—And Isn’t—Income,” at the end of the chapter.

Now let’s see what expenses you can deduct from your business income to get your net profit number as low as possible. Keep in mind that all of these deductions are “double tax savers.” They reduce both your income tax and your Social Security and Medicare contributions.

What Is a Deductible Business Expense?

Congress knows you have to spend money to make money. So, the Internal Revenue Code (IRC) says that just about any expenditure that is made to produce business income is deductible. Then, the tax code lays down about a million rules telling exactly how and when you can and can’t deduct things. Luckily, relatively few restrictions apply to the average small time operator, like you and me.

The Rule for an Expense to Be Deductible

To qualify as a deductible business expense, the expense must be:

- ordinary and necessary for the business
- not extravagant, and
- primarily for the business (not personal).

In other words, money you spend in a reasonable way, with an expectation of bringing in business revenue, is a deductible expense.

Ordinary and Necessary

Okay, so what's an ordinary and necessary expense for a business? The tax code doesn't define it. This means we have to look at court decisions and IRS pronouncements for guidance. One judge said necessary means "appropriate and helpful." Another judge held that ordinary means "normal, common, and accepted under the circumstances by the business community."

When you consider whether an expense is ordinary and necessary, start with a commonsense approach. Most enterprises need a fixed location, for instance, and paying rent or having a home office is appropriate, normal, and common, and is thus considered both ordinary and necessary.

Sometimes the answer is not as clear. For instance, let's say Fifi, a real estate agent, takes prospective clients to Chez Chez for \$100 lunches and drinks to discuss properties for sale. For her business, this is an appropriate, helpful, and accepted business practice (and justified by the five-figure real estate commissions the lunch could generate). But, if Joe the plumber cleans out someone's kitchen drain for \$75 and then takes his customer out to a \$100 lunch, it hardly looks ordinary and necessary. You get the picture.

Some folks try to push the envelope, and the IRS has pushed back. Here's a tax court case that makes the point.

EXAMPLE: Mr. Henry, an accountant, deducted expenses for maintaining his yacht. The IRS audited him and disallowed these costs. Henry contended that since his boat flew a pennant with the number "1040" on it, it brought him professional recognition and new clients. The court held that a yacht wasn't a normal expense for an accountant, and so it was neither ordinary nor necessary. In short,

the yacht was a (nondeductible) personal expense.



TIP

Does your deduction pass the laugh test?

Experienced tax pros can size up a client's potential tax deduction by asking themselves, "Can the expense be listed without provoking a snicker?" By this standard, you could say in the example above that the judge laughed Mr. Henry out of court.

Not Extravagant

Although there's no "too big" limitation on business expenses in the tax law, IRS auditors sometimes find deductions out of proportion to the nature of the business. The tax code (IRC § 162) frowns on "lavish and extravagant" expenses, but doesn't define these terms.

Again, it's more of a commonsense thing. For instance, it's fine for The Gap to lease a jet for travel between manufacturing plants, but not for Sam's Corner Deli owner in Miami to fly to New York to meet with his pickle supplier.

Personal Expenses

The numero uno suspicion of the IRS when auditing small business owners is whether purely personal expenses are disguised as business deductions. Did you use business funds to pay for your son's Bar Mitzvah and deduct it as an "employee party" or as "advertising"?

Other times, it's not so easy to distinguish between business and personal. Would you think the costs of driving to your office and home again are personal or business expenses? Well, commuting costs are spent in pursuit of making money for your business, not for personal pleasure—but the tax code says these costs are not deductible. (For more on commuting expenses, see "Commuting Costs," below.)

**CAUTION**

Payments to relatives (or to businesses owned by relatives) are suspect. It's okay to hire your kids or parents to do work for you, but payments to them must be reasonable and they have to do real work. (For more info, see Chapter 13.) Usually, the IRS finds this out by asking you the question or by noticing that the family names of the payees are the same as yours. Sometimes the issue is raised because the expense seems extraordinarily large to the auditor.

Expenses You Can Never Deduct

Certain things aren't tax deductible—even if they meet all the criteria—because it would violate public policy to encourage these activities. These items include:

- government-imposed fines, like a tax penalty for making a late filing, a speeding ticket, or a parking ticket
- bribes and kickbacks, whether to a local building official or an Arab sheik
- referral payments to get a client or customer, if illegal under a state or federal law, and
- political contributions or payments to purely social organizations.

(For details, see IRC § 162.)

In addition, the value of services can't be deducted. For instance, Dr. Pond performs free eye exams for homeless people every Saturday. Normally, the doctor charges \$100 for this service. He can only deduct his out-of-pocket expenses, not his time. This would likely qualify as an advertisement and promotion expense.

Is It a Current or Future Year Expense?

Tax rules cover not only what deductible business expenses are, but also when you can deduct

them. Most money you spend on your business is deductible right away (on the current year's tax return), but the tax code says that some costs must be spread into future years. Accountants divide this world of expenses into current and capital expenses. Here's how it works:

Current expenses are the everyday costs of running your business, such as monthly phone, rent, and utilities bills. You deduct your current expenses in full from your business revenues in the year they were paid or incurred. Simple.

Capital expenses are costs that will provide benefits to the business beyond the current year. Typically, assets purchased (like machinery, computers, furniture) must be deducted over a number of years (capitalized). The rationale is that because these assets are used over several years, their costs are spread out to match the business revenue they help earn. Asset purchases are subject to special tax rules explained in Chapter 3.

Gray areas sometimes occur when an expense is incurred to repair an existing asset—is it a current expense or a capital expenditure?

A repair is a capital cost if it:

- adds to the asset's value
- appreciably lengthens the time the asset can be used, or
- adapts the asset to a different use.

EXAMPLE: Gunter owns a die-stamping machine that he uses in his business, MetalWorks. He deducts the machine's routine maintenance costs as a current expense each year. After 15 years, the die-stamper is falling apart. Gunter decides to rebuild the machine. The \$80,000 cost to rebuild must be capitalized—it can't be deducted in one year. The tax code says that metal-fabricating machinery costs are deductible over five years. (Chapter 3 explains how long different types of assets must be deducted, or written off.)

Top Deductions for Businesses

Now let's look at the most common deductions for businesses and the rules about how you take advantage of them. The first six are so important that they are discussed at length in other sections of the book. Don't fret if you don't see a favorite deduction of yours on this list. Check the "Commonly Overlooked Business Expenses" list at the end of this chapter for more deductions.

Vehicles

There are very specific rules and limits for deducting vehicle costs, discussed in "Vehicle Expenses," later in this chapter and in Chapter 3.

Equipment and Furniture

Deducting the costs of acquiring assets like equipment and furniture are discussed in Chapter 3.

Inventory

Inventory costs are deducted differently than other costs. (See "Inventory" in Chapter 3.)

Home Office

A home office can produce such large tax deductions that the topic is covered at length in a separate chapter: Chapter 14.

Retirement Account Deposits

Tax-saving contributions to retirement plans are also so important that they get their own chapter: Chapter 16.

Hiring Help

Many, if not most, small businesses will need to bring in workers at some point. These hired hands will either be employees or independent

contractors, each governed by different tax rules. Find out the tax rules related to employees in Chapter 6.

Manufacturers

Businesses that make things have special tax code rules for deducting the costs of production. See "Domestic Production" later in this chapter and IRS Publication 334, *Tax Guide for Small Business*, for details.

Rent

Rent is any expense related to the use of real estate or any other kind of property that is not owned by your business but is used in the operation of your business. It can also be called a lease payment. This type of expense is 100% deductible if it is 100% related to business use. Otherwise, if the rental expense is partly for personal use, like a car you drive for pleasure as well as work, you must reduce the deduction by the personal use percentage.

Costs of Going Into Business

What tax deductions can you take for the money you spend before opening the doors to your new venture? These costs are commonly referred to as start-up costs.

There are three start-up tax rules to choose from, and one bonus rule. Run the numbers trying each of the rules discussed below to see which produces the greatest tax benefit. Most people like to deduct as much as possible right away and would opt for rule one. However, sometimes this doesn't give you the best long-term tax benefit—for example, you think you'll start slow and then be more profitable in future years. In that case, it might be better to choose rule two. Few people choose rule three.

Rule one. You can deduct up to \$10,000 your start-up costs the first year you are in business.

Anything over \$10,000 must be amortized (deducted) over the following 15 years. There are restrictions on this deduction if your start-up expenses exceed \$60,000 for the year. If your first year wasn't profitable and your second year looks iffy, then you might be better off choosing rule two.

EXAMPLE: Sasha starts up Rox, a shop for rock climbers. She spends \$13,000 on ads, travel, and business consultants before opening Rox's doors in September 2011. Sasha can deduct \$10,000 in 2011, and $\frac{1}{15}$ of the remaining \$3,000 (\$200) each year thereafter for the next 15 years.

Rule two. You can deduct ("amortize" in tax lingo) your start-up costs pro rata over 15 years.

EXAMPLE: Sasha chooses to deduct \$867 per year over 15 years ($\$13,000 \div 15$). So, if Rox was in business eight months in year one, Sasha's start-up deduction would be $8 \div 12 \times 867$, or \$578 for that year.

Rule three. You don't deduct any start-up costs; instead, you recover these expenses when you sell the business or close down operations.

EXAMPLE: Sasha picks rule three when she sells her sole proprietorship after two years of operation. Sasha nets a profit of \$10,000 on the sale before considering her start-up expenses. Tax result: Sasha's start-up costs of \$10,000 are considered a (nontaxable) return on her investment in Rox. The balance which has not been deducted in the prior years is a gain on her investment in the business. (The tax treatment of this is explained in Chapter 17.)

Bonus deduction for business organizational expenses. Get an extra up-to-\$10,000 deduction (2011) for small business organizational expenses. This deduction is only for business entities—

meaning corporations, partnerships, and limited liability companies, not sole proprietors. To get the deduction, your total start-up expenses can't exceed \$60,000. This deduction is in addition to the start-up cost deduction discussed above.

EXAMPLE: Sasha pays \$1,250 to a lawyer to form Rox, Inc., \$440 in state fees for incorporating, and another \$100 for a corporate records book. She gets an organizational cost deduction of \$1,790 in year one. This is in addition to her start-up cost deduction of \$8,000, using either rule one or two, above.

For more details, see IRC 195(b) and IRC 2031.

Accounting, Legal, and Other Professional Fees

Business-related fees paid to tax pros, lawyers, and business consultants are always deductible, but sometimes the deduction must be spread over future years.

One-time deals. Professional fees regarding one-time business deals or sales are deductible immediately.

EXAMPLE: Yona hires Carlos, a CPA, to help her prepare payroll tax forms for her business. The \$275 she pays Carlos is a deductible business expense in the year paid.

Long-term benefits. Professional fees that provide a benefit beyond the present year—legal advice on a commercial lease or long-term service or supply contract, for example—must be deducted over the period of the expected benefit.

EXAMPLE: Jackson pays a lawyer \$600 to negotiate a two-year contract to provide cleaning services for the Oakland Coliseum. Jackson must deduct that fee over the 24 months that the lease will last. He can deduct

$\frac{1}{24}$ of the \$600 per month, or \$25 per month. That gives him a deduction of \$300 for each of the two years that the contract will last.

Preopening Cost Exception. You can deduct up to \$5,000 immediately for fees paid to consultants, lawyers, and accountants as long as you begin operations before the end of the same year. Anything over \$5,000 must be amortized (another term for deducted) in equal amounts over the next 180 months or the term of the benefit if that's less than 180 months. If you go out of business in the interim, the balance can be deducted in the final year.

EXAMPLE: Maddy, a sole proprietor, pays her attorney \$600 to negotiate a five-year lease on a mall kiosk to sell Italian charm bracelets. The legal fee can be deducted fully that year or in equal yearly amounts of 120 over five years, or it can be added to the cost of establishing the business. If Maddy sells her business at a gain of \$600 or more, this last choice would reduce the tax bite.

Business and personal tax work. Small business owners' personal and business tax concerns are almost always inseparable, so one tax pro can handle an owner's personal and business issues. These fees, whether business- or personal-related, are always deductible, but different rules apply. The accountant's or tax pro's bill should always split out the business and personal portions. The two separate fees are then deducted on different schedules of the same tax return.

EXAMPLE: Aaron goes to Bridget, his accountant, for tax preparation and advice on how to reduce his family's income taxes. His self-employed income is from the model airplane newsletter he publishes as a sole proprietor. His wife Clarinda is employed as an architect. Bridget's statement for services of \$800 shows \$550 for Aaron's business

Costs of Not Going Into Business

What happens if, after spending money to set up a new business, you back out before opening day? Taxwise, your costs aren't deductible as business expenses, but they may be deductible as investment expenses. Expenses of trying, but failing, to go into business fall into two tax categories (IRC § 195).

Rule One: Investigating a business to start or buy. The costs of a general search for a business to buy or of investigating whether to start a business are not deductible at all—not as business expenses or investment expenses.

EXAMPLE: Bubba is thinking about opening a fried chicken restaurant, so he travels the state for two weeks stopping at every KFC, takes photos of the operation, and samples all the menu items. After spending \$1,244, battling indigestion, gaining ten pounds, and thinking about the long hours, Bubba forgets about it. Result: No tax deduction.

Rule Two: Attempting to buy or start a specific business. The costs of attempting to acquire or start a specific business are deductible as investment expenses.

EXAMPLE: Francine, an experienced hairdresser, sees an ad for a Hair Today, Gone Tomorrow (HTGT) franchise for sale 600 miles away. She travels to meet with the owner, hires an attorney, and signs a contract to buy it. HTGT's home office doesn't approve the transfer because Francine isn't a licensed beautician in this state. Francine is out of pocket \$3,100. She can deduct this not as a business expense, but as a "miscellaneous expense," on Schedule A of her Form 1040 individual tax return.

and \$250 for the couple's personal tax matters. Tax result: \$550 is tax deductible for Aaron's business (Schedule C) and \$250 for miscellaneous items (Schedule A) on Aaron and Clarinda's joint tax return.



TIP

Maxing out the tax professional fee

deduction. Ask your tax pro to apportion his or her bill to attribute the lion's share to the business expense. While the personal part may be deductible on your individual tax return, it is subject to limitations.

Office Supplies

You can deduct items like paper clips, brooms, coffee, and snacks. Just categorize them as "office" or "supplies" on your business tax schedules and returns. To be 100% immediately deductible, they should be used up within the year they are bought. While this is the law, the IRS knows it is impractical to expect a business to run out of its supplies on New Year's Eve, so auditors rarely question these types of items.

Entertainment and Meals: The 50% Rule

Deductible business entertainment can be any activity for amusement or recreation, as long as it's for your business's current or prospective customers, clients, or employees. This includes wining and dining, going out to a nightclub, attending a ball game or the theater, or taking a fishing trip. That's the good news. The bad news is that there are some major drawbacks and limitations to its use. Here are the rules:

50% rule. Only 50% of the expense is deductible (with a few exceptions noted below).

Appropriate and accepted. The entertainment must be both:

- common and accepted in your field of business, trade, or profession, and
- helpful and appropriate.

An entertainment expense does not have to be indispensable for your business to be deductible. Nor do you have to show that you received any business income from the entertainment.

EXAMPLE: Barney's Building Supplies throws an annual golf tournament for local building contractors. Providing this type of outing—golf, baseball games, and the like—is fairly common in the industry. Barney shouldn't have a problem deducting 50% of the expense as an entertainment expense.

Related to business. The entertainment also must be for the purpose of bringing in revenue. The entertainment must be either directly related to or associated with your business. Directly related to your operation means that there must be a substantial business discussion during the entertainment. It must occur in a clear business setting, and there must be more than a general expectation of business.

EXAMPLE: Ginny, a housewares wholesaler, hosts a group dinner for her distributors at Glutton's restaurant. She demonstrates a new electronic toothpick to potential customers while they dine. This should meet the directly related rule.

Associated with your business means that there must be a substantial business discussion either prior to or immediately after the entertainment.

EXAMPLE: Edmund, a financial adviser, holds a tax-planning seminar for a group of clients followed by an evening at the symphony that he pays for. The symphony trip satisfies the associated-with rule.

Extravagant entertainment. An IRS auditor can reject entertainment deductions that are lavish and

extravagant for the business. Use your common sense and don't be excessive.

Home entertaining. You can deduct only 50% of your costs for wining and dining existing or potential customers or clients in your home.

EXAMPLE: Denise holds a dinner party to show and sell MegaVega Vitamins, a multilevel marketing scheme she got suckered into by her brother-in-law. Denise spent \$100 on food and drinks and can deduct \$50 under the 50% rule.

Entertaining spouses. You can deduct the costs for spouses of customers or clients included in the entertainment as long as the occasion otherwise qualifies as deductible entertainment. And if other spouses are attending a social event, you can bring yours, too (and deduct the cost).

Exceptions to the 50% deduction rule. The following expenses are 100% deductible:

- **Transportation.** If you go to an event with a client or customer, your transportation costs are 100% deductible. So, go ahead and hire that limo.
- **Employee parties.** Company parties and outings for your employees and their families are 100% deductible. No business need be discussed, but everyone in the company must be invited—even the geeks in the back room.
- **Public entertainment.** Entertainment and meals for the general public are fully deductible as a form of advertising.
- **Events for charitable organizations.** You can deduct 100% of the costs of a putting on a charitable event if the entire net proceeds benefit the charity and most of the work is performed by volunteers.
- **Clubs and athletic facilities.** See Chapter 15 for rules about how to deduct the costs of entertaining at clubs and athletic facilities.



CAUTION

The IRS looks closely at business entertainment deductions. Auditors are suspicious of fun-and-games deductions. Keep a guest list of people you entertain, and note the business connection and nature of business discussed. At the same time, I've never seen the IRS contact a guest to see whether or not business was really discussed.

C corporation entertainment. Small business C corporation shareholders or employees working in the business have two ways to claim entertainment expense deductions. They may either pay the entertainment expenses and get reimbursed or have the corporation pay the expenses directly. If they pay and are not reimbursed, the shareholder/employees can claim the entertainment costs as "unreimbursed employee expenses." This is an itemized expense they must claim on Schedule A of their individual income tax returns. This is the least desirable way to claim the expenses because it's less advantageous tax-wise, and it also increases the chances of being audited.



RELATED TOPIC

See "Travel," below, for more on meal expenses while traveling.

Gifts to Clients and Customers

Gifts to clients and customers are deductible up to a very stingy limit of \$25 per recipient, per year. You can get around the limit, a little, by adding on the cost of engraving, wrapping, and mailing. Also, if the gift costs less than \$4 and your business name is imprinted on it (like a calendar or pen) it doesn't count against the \$25 limit and is fully deductible.



RELATED TOPIC

Gifts to employees can be much more generous. See "Gifts, Rewards, Discounts, and Free Services" in Chapter 15.

Travel

Business travel expenses are deductible as long as they are “ordinary and necessary.” The IRS defines travel as a trip away from your place of business, not your residence. There are a number of special rules about these deductions that you should be aware of because the deductions work differently depending on the nature of the travel expense involved.

Transportation. Whether plane, train, or automobile, public or private, transportation is 100% deductible—except for commuting from home to work. This includes taxis, buses, and limos and cash tips. It also includes vehicle costs for your personal car, according to the rules discussed below in “Vehicle Expenses,” along with rental cars, tolls, and parking.

Baggage and shipping. You can deduct 100% of the cost of transporting items, like sample or display material and personal luggage, as long as it is all needed for your business travel.

Lodging. When a trip takes you away from home overnight, or you need to be able to rest to be able to perform your job, you can deduct 100% of the costs of overnight lodging.

Meals. You can deduct only 50% of the costs of food, beverages, and tips when you’re on the road. Lawmakers reason that you would still have to eat if you were at home and home-cooked dinners aren’t deductible.

Tips. Gratuities for services like cab drivers, messengers, and porters are fully deductible for business—with one exception. Only 50% of a tip to a food server can be deducted along with the meal costs, as mentioned above.

Laundry. You can deduct 100% of your costs for cleaning your clothes while you are traveling away overnight on business. You don’t get any deduction for the costs of keeping your businesswear clean while you are at home.

Incidentals. Charges for telephone, Internet access fees, and anything else directly related

to your business travel are 100% deductible. Catching a play while you’re out of town comes out of your pocket, though, unless you are entertaining a client or customer.

Deducting travel expenses

You have a choice of how to deduct your living expenses while traveling away from home on business. Travel costs (other than transportation to your destination, which is deducted separately) are termed “lodging, meals, and incidental” by the IRS.

Use either the actual expense or the per diem expense method to deduct meals and incidentals. You will want to figure it both ways and use the one that gives you the bigger tax break.

Actual expense method. With this method, you must keep track of every cent you spend for travel, including food and lodging on the road. Keep good records, by hand or electronically, and don’t throw away your receipts and credit card statements.

Per diem method. The per diem (per day) expense method is simpler—just take an IRS-approved specific dollar deduction for each day you are on the road. How much you can take depends on where you are traveling.

To find the per diem rate for where you are going, see IRS Publication 1542, *Per Diem Rates*. This publication can be found on the IRS’s website at www.irs.gov. The tables for each method show the rates, which range from approximately \$165 to \$260 per day for lodging depending on the location. Meal and incidental expense rates range from approximately \$45 to \$65 per day.

The per diem method relieves you of keeping close track and records of these expenses, although you still must be able to document the trip and the business nature of the travel. Keep your calendar, day-timer, or appointment book showing the business purposes.

The IRS has announced that it plans to discontinue the per diem method for lodging,

meal, and incidental expenses. It will publish new rules and procedures for substantiating these expenses sometime in 2011. Check the IRS website for updates.



CAUTION

Travel per diem expense deductions for lodging can be used by employees only—not small business owners. However, solos may use the IRS per diem meal rates (rates vary depending on the locale) and then claim the actual expense for their Holiday Inn stay. (See IRS Publication 1542 for current IRS per diem rates.)



RELATED TOPIC

Combining business and pleasure travel is discussed in Chapter 15.

Moving Expenses

Did you move your residence because of a change in your business location? You can deduct moving expenses if you meet one of the following rules:

- The relocated business site is at least 50 miles farther from your old home than your old business site was, or
- If you're starting up a new business instead, the new business site is more than 50 miles from your former home.

Qualified personal moving costs are not business expenses but can be claimed on Schedule A of your personal tax return if you itemize your deductions. (See IRS Publication 521, *Moving Expenses*, for details.) The cost of moving your business equipment and goods is a deductible business expense that you can claim on your business tax schedule or business entity tax return.

Health Insurance

Premiums paid for health insurance for your employees are 100% deductible as an ordinary

business expense. This includes doctors, medicine, hospitalization, and long-term care premiums.

The rules for deducting health insurance premiums that owners pay for themselves are different:

- The health insurance deduction can't be greater than the business's net profit.
- Owners who are eligible for coverage by a spouse's health plan cannot claim this deduction for themselves—whether or not they are covered by their spouse's plan.
- Health insurance premiums that a business owner pays for him- or herself are not business expenses. Instead, owners claim 100% of these expenses as a personal itemized deduction on the first page of Form 1040, their individual tax return. For more information, see Chapter 15.

Disability and Sick Pay

Many small businesses keep a sick worker on the payroll. Wages paid to sick or disabled employees (but not to you, the owner) are deductible. There should be a written wage continuation policy in case you are audited. Any sick pay received is fully taxable to the worker, just like wages, and is reported on Form W-2 as income.

Education Expenses

Tuition, fees, books, and supplies are business deductions if they are related to an established business, trade, or occupation (IRC § 162). The education must be either:

- to maintain or improve skills required in your business, or
- required for your work by law or by your employer, which includes you if your business is incorporated.

EXAMPLE: Horatio is required by his state to complete 24 hours of continuing education before renewing his electrical contractor's

license. The course fee and workbooks cost \$720, and the course requires a flight and two nights' stay in a hotel. Horatio's total outlay of \$1,130 is a deductible education expense, under either of the two rules above.



CAUTION

Education that qualifies you for a new job or different business isn't deductible. If you are trying to improve your skill set to change jobs or start a new business, the expenses are not deductible. The IRS and the courts interpret this rule quite strictly.

EXAMPLE: Mary, a public school teacher, wants to open a small private school for learning-disabled children. Her state requires special college-level courses before she can be certified to establish her school. She spends \$5,000 on the classes. Tax result: No deduction for Mary, because the education is for a new job or business, even though it's in a related field and would no doubt help her in her current job.



TIP

Non-business-related higher education tax credit. If you earn less than \$65,000 (single) or \$130,000 (married), you may be able to claim a tax credit of up to \$4,000 annually in college or vocational school tuition and related fees for yourself, your spouse, and dependents, whether or not you're in business. These nonbusiness education tax credits are the Hope credit, the Lifetime Learning credit, and the American Opportunity credit. For details on qualifying and claiming the credits, see IRS Publication 970, *Tax Benefits for Education*.



RELATED TOPIC

Also see "Education Benefits" in Chapter 15. This covers rules on education costs as a fringe benefit when they are provided to owners or employees.

Deducting Your Work Clothes or Uniform

Uniforms and work clothes for employees and owners are deductible if they are required by the employer and are not appropriate for everyday wear off the job, such as a nurse's outfit, bus driver's uniform, or Century 21 yellow jacket with the business logo prominently displayed on the back. If it meets the test, you can deduct both the cost of the clothing and your cleaning bills. However, if you're an attorney at a law office and your boss requires a coat, tie, and business suit, you can't deduct your clothing costs because this clothing is appropriate for nonwork situations.

Interest

You can deduct interest charges paid for loans or credit (on goods or services) for your business. This includes credit card charges and ATM fees. You get the deduction whether the loan was extended to you personally or to the business entity. The rule is different if your business is a C Corporation (see Chapter 8).

EXAMPLE: Zee Zee maxes out her Visa card with a \$5,000 cash withdrawal and uses it to fund her House of Pain Piercing & Tattoo Salon. The 21% credit card interest that Zee Zee pays is deductible—but she should be prepared to show an auditor that all of the cash advances went into the business. Otherwise, some of the interest is a (nondeductible) personal expense.



TIP

Consider a home equity loan or line of credit first. Loans secured by real estate always carry lower interest rates than credit cards, and they allow longer periods for repayment. These loans can be used to finance a business—the interest is deductible no

matter what the loan is used for (up to \$100,000 on a second mortgage or home equity loan). The downside is the bank fees and costs involved in getting the loan, but these are usually deductible too. If this looks promising, run the numbers by a tax pro first.

Bad Debts

If you're in business long enough, you'll get stiffed by at least one deadbeat customer or client. There are three tax rules for deducting different categories of losses. (IRC § 166 and Reg. 1.166.)

Goods. The costs of goods sold by your business and not paid for can be claimed as a bad debt deduction. You can deduct only your cost of the goods, not any lost profits.

EXAMPLE: Tom's Tires sells a set of Brimstone tires to Bianca for \$450. She pays \$50 down and talks Tom into letting her pay the balance "next month." Bianca disappears. Tom paid \$350 for the tires, and so he gets to deduct \$300 (counting the \$50 he got from Bianca) as a bad debt.

Services. A professional can't deduct the value of services performed that weren't paid for: consulting, medical treatment, legal work, and so on. Uncle Sam's apparent rationale is that if you could deduct the value of your unpaid services, it would be easy to inflate your bills and claim large bad debt deductions—and too hard for the IRS to catch you.

Loans. Money loaned by a business and not repaid can be deducted as a bad business debt, if both of the following are true:

- The loan was made for business (not a personal loan to Regis, your ex-best-friend before he ran off with your wife).
- You have taken reasonable steps to collect it—such as a written demand for payment, going to court, or turning the bill over to a collection agency.

EXAMPLE: Print It Now made a \$2,000 loan to Susan, a friend and long-time customer, to keep her Flowers To Go business afloat. Several months later Susan declared bankruptcy. Print It Now filed a claim in the bankruptcy and received a \$300 repayment of its loan. Tax result: As long as Print It Now made the loan to protect a business relationship—and not just to help a friend—\$1,700 is deductible as a bad debt (\$2,000 minus \$300).



TIP

Deducting nonbusiness bad debts. Bad debts that you hold personally without any business connection may still produce a tax benefit. This book is for business owners so we don't cover personal debts. If you got stiffed on a personal loan, see IRS Publication 560, *Investment Income and Expenses*.

Charitable Contributions

Most of us like to help the needy, but only C corporations can claim donations to charity directly as business expenses.

However, charitable deductions can be claimed by all individuals, whether or not they are business owners. Sole proprietorships, partnerships, LLCs, and S corporation owners can claim charitable deductions made by their business on Schedule A of their Form 1040 individual tax return.

EXAMPLE: Belinda, a sole proprietor, buys a new nail gun and air compressor for her drywall contracting business. She donates her old equipment to a nonprofit, Habitat for Humanity. Belinda originally paid \$2,000 for the donated items and took \$1,100 in depreciation deductions so her tax basis in the old equipment is \$900. She gets a \$900 charitable contribution on her personal tax return as an itemized deduction (not

a business expense). This assumes the old equipment was worth at least \$900. If it was worth less, say \$500, then she could deduct only \$500. (We'll discuss how Belinda figures her depreciation deduction in Chapter 3.)

Taxes

The many taxes paid by a business are deductible—with some notable exceptions. Here are the rules:

Income taxes. Federal income taxes are never tax deductible. However, individuals can deduct state and local income taxes on their individual federal return if they don't take the standard deduction. In other words, they must itemize all their personal tax deductions on Schedule A of their Form 1040.

Self-employment taxes (Social Security and Medicare). If you're in business and not incorporated, you can deduct 50% of your personal Social Security and Medicare taxes. You take the deduction on the first page of your Form 1040 tax return. The form lists this as an "adjustment" to income, but it works like a deduction.

Real estate taxes. Regular state and local taxes on real estate used for business are deductible business expenses. However, if your business is home based, you must list this expense on Form 8829, which is filed with your individual tax return. (See Chapter 16 for details.)

Special tax assessments on real estate. State or local tax assessments for improvements on or near your business property are not fully deductible in one year. Generally, these costs must be amortized (deducted in equal amounts) over 15 years. See Chapter 3 for rules on writing off long-term property improvements.

Sales taxes. You can deduct state and local sales and use taxes on ordinary business expenses as part of the cost of the item. For instance, \$25 of office supplies with \$2 sales tax is deductible as \$27; you don't deduct the sales tax separately.

However, you must deduct sales taxes on assets you purchase for the business over the life of the asset or by using Section 179. (See "Tax Basis of Business Assets" in Chapter 3.)

Sales taxes a seller takes in for a state or local tax agency should be accounted for separately from the sales. Sales taxes aren't included in a business's gross sales. Your state will gladly provide you the forms and rules for accounting and payment of its sales taxes. A handful of states, including Delaware and Oregon, don't have sales tax. Check with your state tax agency to see what the rules are in your state.

Government penalties and fines. There is no deduction for penalties or fines paid to a domestic or foreign government agency, including the IRS. This means items like late tax payment charges, speeding and parking tickets, and fines for building code and license violations. Bribes and kickbacks aren't deductible either. The government's rationale is that allowing such tax deductions would be against "public policy"; not to mention, you could go to jail, too.

Excise and fuel taxes. Few businesses, other than trucking and transport, pay excise and fuel taxes, but they are fully deductible. The most common excise taxes are:

- Manufacturers' excise taxes on vehicle accessories, such as tires and inner tubes, gasoline, lubricating oils, coal, fishing equipment, firearms, shells and cartridges sold by manufacturers, producers, or importers.
- Fuel excise taxes imposed at the retail level on diesel fuel and special motor fuels.

See IRS Publication 3536, *Excise Tax Guide*.



CAUTION

Sales taxes are part of the cost of the asset.

State and local sales and use taxes paid on business assets—such as a vehicle—must be added to the asset's tax basis. They are then claimed as depreciation deductions over future years. In other words, you can't

deduct these taxes in the year you bought the business asset. (See Chapter 3.)

Advertising and Promotion

Marketing costs are fully deductible. This includes costs for websites, public relations consultants, business cards, and yellow pages listings, as well as customer prize drawings or sponsoring a Little League team. As long as there is a *clear business connection* with the advertising or promotional activity, it's deductible. For instance, putting "Southwest Autoparts" on the back of a team's jerseys is a deductible cost as is anything that promotes your business.

Signage that has a useful life beyond one year is classified as a capital asset and can't be deducted all in one year. (See Chapter 3.)



CAUTION

Don't get too creative. You can't deduct things that are primarily personal, like the cost of inviting clients or customers to your daughter's wedding reception, even if it may incidentally help your business's visibility.

Business Licenses and Permits

Any fee paid to a government agency that is required to operate your business is fully deductible. The same is true for fees paid to quasi-governmental agencies, like state bar associations and medical boards. However, fines and penalties paid to government agencies for violations of law, like a building code violation, are not deductible.

Repairs and Improvements

You can fully deduct the cost of everyday repairs to business assets in the year the repair is made.

However, the cost of improvements which add to the life of an asset must be depreciated over a number of years. (See "Is It a Current or Future Year Expense?" above, and Chapter 3.)

EXAMPLE: The electrical system in Pat's Postal & Shipping's building is outdated and frequently blows fuses. The service can be upgraded to a breaker box and new wiring throughout at a cost of \$4,700. A repair to keep things going awhile longer costs \$425. Tax result: The \$425 repair would be currently deductible as an operating expense. To replace the old system with new electrics for \$4,700 would be only partly deductible this year, and the balance of the cost could be depreciated over future years.



TIP

Improving accessibility or restoring historic buildings may qualify for instant deductions or tax credits. Special tax breaks are granted for rehabilitating historic and older buildings, adding elderly or disabled access, and removing architectural and transportation barriers. Check with your tax pro or see the instructions for IRS Form 3800, *General Business Credit*; Form 3468, *Investment Tax Credit*; and Form 8826, *Disabled Access Credit*.

Casualty Losses

A business casualty is the damage, destruction, or loss of business property from events such as floods, fires, tornados, and hurricanes.

To qualify as a tax deductible business casualty loss, the event must be sudden (roof blown off your business in a hurricane) and not gradual (like a long-time leaky roof that finally caves in). The occurrence must have been an unanticipated event (like a tornado), and it must have been unusual (your building burns down).

To claim a business casualty loss, you must list it as a business expense and also attach IRS Form 4684 to your tax return. To help stave off an audit of a large casualty deduction, staple a few photos and news clippings of the catastrophic event to Form 4684. For information on deducting losses from casualties in federally declared disaster areas, call FEMA at 800-621-3362.

For your personal (nonbusiness) casualty losses, like from a fire or flood, see the deduction rules in IRS Publication 547, *Casualties, Thefts and Disasters*.

Business Insurance

Businesses can deduct 100% of the premiums they pay for insurance, including:

- **Vehicle insurance.** (But see “Vehicle Expenses” later in this chapter.)
- **Credit insurance.** Covers losses from bad debts.
- **Liability insurance.** Covers general liability issues, such as a customer who slips and falls inside your store.
- **Malpractice, errors, and omission.** Covers mistakes in providing services to business clients.
- **Overhead insurance.** Covers your business expenses for long periods of disability caused by injury, sickness, or a disaster.
- **Workers’ compensation and unemployment insurance.** Coverage is mandated by state and federal law for most businesses with employees.
- **Business interruption or overhead insurance.** Covers financial losses if, for instance, your building is flooded and you have to close your doors for a few weeks.
- **Life insurance.** Deductible only if the premiums are paid for the employees and the business owner is not the beneficiary.

For other types of insurance that may be deductible, see IRS Publication 535, *Business Expenses*.

Research and Development Credits

The tax code allows a tax credit of 20% (as opposed to a tax deduction) for “research or experimental” expenses. This includes the development of an invention, formula, or process to develop a product, process, or patent, for instance, Gary Geok’s costs for developing software to predict hurricanes. Tax credits are similar to deductions, only more valuable. A credit is a dollar for dollar reduction of your tax bill. The credit, however, can’t exceed the business income.

To qualify, the research must be “technological in nature ... useful in your new or improved business component ... constitute elements of a process of experimentation.” (IRC § 174, IRC § 41.) If this sounds promising, check with a tax pro to see if you qualify as the rules are complicated.

Domestic Production

This is a fairly new tax deduction that can provide a potentially huge tax break for an estimated half-million United States based businesses engaged in manufacturing and related activities. Many enterprises can take advantage of this provision, including filmmakers, agricultural and mining businesses, construction businesses, and software producers. Even some professionals, such as architects and engineers, can qualify for the deduction. Congress put this provision into the tax code to discourage United States businesses from outsourcing abroad.

The domestic production deduction is a bonus, meaning it’s taken over and above any other deductible business expenses you may be entitled to. Your business must have at least one employee and be located within the United States borders. Presently, the deduction is 9% of a business’s gross income, but the rules are complicated. To claim it, file Form 8903, *Domestic Production Activities Deduction*. Check Section 199 of the tax code or run it by a tax pro to see if you qualify.

Deducting Intangible Property

Intangible property is an asset that can't be seen or touched, such as a patent or copyright. A business owner normally must deduct (the tax code calls it "amortize") intangible property costs over a 15-year period, in equal amounts each year. Some of the more common types of intangible property that must be amortized include:

- patents and copyrights
- customer or subscription lists, location contracts, and insurance expirations
- designs, patterns, and formats, including certain computer software
- franchises, and
- certain agreements not to compete.

Some intangibles can be deducted, in whole or in part, all in the year of the expense, such as certain start-up costs and professional fees (see "Costs of Going Into Business" and "Accounting, Legal, and Other Professional Fees," above).

Most small businesses don't own intangible assets. But if your business acquires or owns any intangibles, seek professional advice and see IRS Publication 535, *Business Expenses*, and IRS Form 4562, *Depreciation and Amortization*, and its instructions.



TIP

Can't find a category? IRS tax forms (such as Schedule C for self-employed people), have a catch-all category—"other expenses"—to list items that don't seem to fit elsewhere. This could include items such as professional or business organization dues or subscriptions, website development, or education related to your trade or business.

The General Business Credit

The general business credit (GBC) is a broad term used for a number of different tax credits. We'll cover these credits only briefly in the chart below

because so few small business owners can take advantage of them. The GBC is a tax credit that reduces your tax liability—it is not a tax refund.

You claim the GBC on IRS Form 3800 (along with other appropriate forms listed in the chart below) with your tax return. Beginning in 2010, businesses with less than \$50 million in gross receipts can carry back any unused GBC to offset tax liabilities for five years.

To see whether you qualify for any of these credits or carrybacks, check with your tax pro or the IRS website at www.irs.gov.



TIP

Cash expenses are deductible but ... may be hard to prove to an auditor without some evidence. The IRS understands that even in a credit card world, cash is still around. Small things like tips to service folks, cabbies, waitresses, parking lots, postage, subways, and so on are okay. The IRS will be skeptical, however, if you say you bought a Hummer for cash. Expect an annoying "where'd you get the money" question. I jot down out-of-pocket cash items at the bottom of my day-timer, and transfer them to *Quicken* once a month. If you claim over several hundred dollars, make sure you have an explanation of where the cash came from—the petty cash drawer, ATM, or cash sales at your business.

Vehicle Expenses

Vehicles are well-known money-eaters—businesses' second biggest expense besides employees. The good news is that vehicle costs for business can yield one of your largest expense deductions.

Tax rules for claiming car and truck expenses are tricky, but well worth knowing. Here are the three basic rules:

Rule 1: Keep records. Use a trip or mileage log to record vehicle use (see sample below), and save gas and repair receipts and credit card statements. You'll need this data when you do your tax return

General Business Credits	IRS Form
Welfare-to-work credit. For hiring and paying wages to long-term family assistance recipients.	IRS Form 8861, <i>Welfare-to-Work Credit</i>
Work opportunity credit. For providing jobs to disconnected youth, unemployed veterans, and individuals from certain countries.	IRS Form 5884, <i>Work Opportunity Credit</i>
Indian employment credit. For hiring certain Native Americans.	IRS Form 8845, <i>Indian Employment Credit</i>
Child care facility credit. For providing a day care facility for your employees' children.	IRS Form 8882, <i>Credit for Employer-Provided Childcare Facilities and Services</i>
Low-income housing credit. For building and providing housing to folks falling under certain income levels.	IRS Form 8586, <i>Low-Income Housing Credit</i>
Investment tax credit. Composed of credits for rehabilitating property, energy, and reforestation.	IRS Form 3468, <i>Investment Tax Credit</i>
Alcohol fuels credit. For using alternative fuels in your business equipment and vehicles.	IRS Form 6478, <i>Credit for Alcohol Used as Fuel</i>
Community development credit. For contributions to qualified community development corporations.	IRS Form 8847, <i>Credit for Contributions to Selected Community Development Corporations</i>
Disabled access credit. For making your goods and services more accessible to individuals with disabilities.	IRS Form 8826, <i>Disabled Access Credit</i>
Pension plan start-up cost credit. See IRS Publication 560, <i>Retirement Plans for Small Businesses</i> .	IRS Form 8821, <i>Tax Information Authorization</i>

and to prove your deductions in case you ever get audited.

Rule 2: Allocate business/personal use. If you use your business vehicle for pleasure driving, the IRS requires you to keep track of your use. This is really just another record-keeping issue, but it deserves special mention. You can record either your personal miles or your business miles and your total annual mileage. For your tax return, you'll need to come up with numbers like "62% business," leaving 38% personal. IRS auditors can get very testy if you can't produce backup data.

I track my business miles, not my pleasure driving. At tax time, I subtract the business miles

from what shows on the speedometer, and I figure that any miles not driven for business must be nondeductible personal ones.

Minimal personal use, like occasionally heading a few miles out of your way for lunch while driving for business, is not going to excite the IRS—you don't have to account for it.



CAUTION

Do you use your personal vehicle for business? As a rule of thumb, if you only have one car or truck, don't claim over 80% business use and expect it to fly with an IRS auditor. The auditor will suspect that your personal miles are higher than you're admitting.

Rule 3: Choose a deduction method. You can use the standard mileage method or the actual expense method to deduct your vehicle expenses—whichever gives the bigger deduction. We'll explain both next. Generally, you should run the numbers using both methods and then choose one. With tax preparation software, this comparison can be done automatically.

You are allowed to switch back and forth between the two methods every year (with some limitations discussed below in “Actual Expense Method”).

Standard Mileage Method

The absolute simplest way to deduct business vehicle expenses is called the mileage or standard mileage method. You can choose the mileage method whether you own or lease your auto or truck.

However, don't automatically choose this method until you have considered the second alternative.

Here are the steps for using the standard mileage method:

1. At the end of the year, add up the number of business miles you drove. You're not supposed to use an estimate, but a lot of people do anyway, especially when the same trip is repeated many times.
2. Enter the total business miles number on your tax return (for Schedule C sole proprietors, it is on Schedule C or Form 4562).
3. Multiply the total number of business miles by the IRS standard mileage rate in effect for that period of time. The IRS rate for the first six months of 2011 (January 1 through June 30) is 51 cents per mile. The IRS usually sets the standard mileage rate annually but decided to increase it to 55.5 cents per mile for the second half of the year because of the increases in gasoline prices.

4. Add the cost of parking, tolls, and state vehicle taxes to get your total vehicle deduction.

EXAMPLE: Dr. Morris, a veterinarian, buys a specially equipped GMC pet hospital truck for \$25,000 and drives it 5,000 miles during the first six months of 2011 and 5,000 for the second six months of the year. The doc chooses the mileage method, giving him a deduction of \$5,325 for the miles driven (5,000 miles $\times$ 51 cents + 5,000 $\times$ 55.5 cents). He also spends \$350 for highway and bridge tolls, \$100 for the property tax portion of his state vehicle registration, and \$250 for parking. Tax result: Doc Morris's total vehicle deduction is \$6,025 (\$5,325 + \$350 + \$100 + \$250). This assumes that the doc uses the pet hospital van 100% for business.

When you can't use the mileage method. You must use the actual expense method of deducting vehicle costs instead of the mileage method when any of the following conditions apply:

- You used more than one vehicle in one business simultaneously.
- You used the actual expense method on this same vehicle in prior years, and also claimed an accelerated depreciation method to deduct the cost of this vehicle (explained in “Depreciating Business Assets,” in Chapter 3).
- You used Section 179 to write off all or part of the vehicle's purchase price (explained in “Section 179: Expensing Business Assets” in Chapter 3).

Actual Expense Method

The actual expense method requires more record keeping, but it is usually well worth it. For most newer vehicles, the actual expense method produces a bigger deduction than the mileage method. That said, the mileage method may

produce bigger deductions if you drive a lot in a gas miser or a faithful old clunker.

Here are the steps for using the actual expense method:

1. Record all vehicle out-of-pocket operating expenses, such as gas, insurance, garage rent, lease payments, licenses, maintenance, repairs, parking and tolls, and tires. (See the Vehicle Expense Log, below.)
2. Add the annual depreciation deduction (discussed briefly below and in detail in Chapter 3).
3. Total the numbers in items 1 and 2. If the vehicle is used 100% for business, you're done. That amount is your actual expense deduction.
4. If you also use your vehicle for personal purposes, there's one more step. Calculate the percentage of business miles versus personal use you drove for the year and convert this to a percentage. For example, a vehicle driven a total of 10,000 miles, with 6,200 for business, has 62% business use. Multiply the total in item 3 by your business use percentage and that's your actual expense deduction. For example, if your actual expense amount in item 3 totaled \$12,500, you multiply that number by 62% to calculate your vehicle deduction ($\$12,500 \times 62\% = \$7,750$).

Figuring depreciation. Depreciation deductions are the main topic of Chapter 3. But here's a preview to help you understand the example below.

Depreciation is a tax term for deducting the cost of any business asset that wears out over time—as your car goes from New & Shiny to Dented & Smelly. The IRS publishes tables to show the maximum dollar amount you can deduct for vehicle depreciation each year, based on variables like whether you bought new or used and how much you paid for it.

Passenger vehicles purchased in 2011 have a first-year depreciation deduction limit of \$3,060.

Trucks and vans are \$3,260. (To find out how much you can deduct after the first year, and for some tricks for getting around the depreciation limit, head over to “Depreciating Business Assets” in Chapter 3.) For 2011, there's a special first-year bonus depreciation (see Chapter 3).

Now, here's an example of the actual expense method that can add \$7,000 to the deduction limits above.

EXAMPLE: Samina does floral arrangements for weddings. She buys a Dodge minivan for \$25,000 (coincidentally, the same amount her hubby paid for his pet hospital truck). Samina drives 10,000 business miles and spends \$700 for gas, insurance, maintenance, and parking—the same as hubby's out-of-pocket costs. She chooses the actual expense method and uses the van 100% for business. Tax result: Samina gets a depreciation deduction of \$3,260. Adding this to Samina's \$700 operating expenses, she has a total of \$3,960 in vehicle deductions. But see Chapter 3 for more on a special bonus depreciation for vehicles purchased in 2011, which would allow Samina to claim an additional \$8,000 write-off.



TIP

Run the math both ways each year and switch back and forth. You may switch between the two methods every year, with two limitations:

- If you use the actual expense method in the first year you use your car in your business, you can't switch to the mileage method in any later year.
- If you use the mileage method in the first year you use your car in business, you can switch to the actual expense method only if you take straight-line depreciation deductions instead of accelerated depreciation deductions. (This distinction is covered in Chapter 3.)

Record Keeping for Business Vehicles

No matter which method you use to claim auto expenses, you will need to keep accurate records. One way to keep auto use records is with a logbook that you can purchase at an office supply store. Or, keep a notepad in your glove compartment. If you prefer a more high-tech method, store the vehicle data on your smartphone or use a computer program (see www.bizmiletracker.com). However you do it, whenever you drive a personal car for business, keep a record of:

- the date of the trip

- your destination
- your mileage (round trip), and
- who you visited and your business relationship with that person.

Below is a sample page from a logbook showing vehicle expense entries.

Also, keep vehicle-servicing receipts showing the mileage at the first and last servicing of the year. This is one way to prove the total annual miles if you are audited. If you are using the actual expense method, save all of your other car expense receipts, too.

Vehicle Expense Log

January 2011			<u>Odometer Readings</u>			<u>Expenses</u>	
<u>Date</u>	<u>Destination (City, Town, or Area)</u>	<u>Business Purpose</u>	<u>Start</u>	<u>Stop</u>	<u>Miles this trip</u>	<u>Type (Gas, oil, tolls, etc.)</u>	<u>Amount</u>
1/18/11	Local (St. Louis)	Sales calls	8,097	8,188	91	Gas	\$18.25
1/19/11	Indianapolis	Sales calls	8,211	8,486	275	Parking	2.00
1/20/11	Louisville	See Bob Smith (Pot. client)	8,486	8,599	113	Gas/ Repair flat tire	16.50
1/21/11	Return to St. Louis		8,599	8,875	276	Gas	17.25
1/22/11	Local (St. Louis)	Sales calls	8,914	9,005	91	Gas	18.25
1/23/11	Local (St. Louis)		9,005	9,005	0	Car wash	8.50
///	MONTHLY TOTAL	///	8,097	9,005	846	///	\$80.75
TOTAL JANUARY 2011			Business miles driven		846	Expenses	\$80.75

This process is easy if you are using a tax program like *TurboTax* on your computer.

Commuting Costs

Whether you drive, fly, or use public transportation, you can't deduct the cost of getting to work. Commuting expenses, such as gas to get to and from work, are considered personal, with two exceptions.

- **Home office.** If your business is home based, all trips from your house to a job site or client, or to buy supplies, are fully deductible. Keep a log in case of an audit.
- **Temporary workplace.** Trips to a temporary work site are deductible if you have a permanent regular workplace. Otherwise, it's a non-deductible commuting expense.



TIP

Do some business on your way home. If you make a business related stop en route (hint), like at Office Depot to pick up a toner cartridge, or to say hello to a customer or client, it could make that trip deductible. Note the business purpose in your vehicle log.

Special C Corporation Vehicle Rules



SKIP AHEAD

Unless your business is operating as a C corporation, you don't need to know this stuff. Skip ahead to the next section below.

The tax rules for deducting vehicle expenses for C corporations depend on whether the company owns the car or the employee (or employee/owner) owns it.

Corporation-owned vehicles. A company car, say a new BMW, is a nifty perk for employees, including company owners—especially when they can drive it to impress their friends off hours. If the corporation uses the actual expense method, then it can deduct all expenses related to that car. The catch is that the value of any personal use of the car is taxable income to the driver. This means the driver must keep a usage log (see sample vehicle expense log, above). If this sounds promising, see a tax pro or IRS Publication 917, *Business Use of a Car*, for details.

Employee-owned vehicles. Small business C corporation employees (remember, that includes you if you are a shareholder working for your incorporated business) often use personal vehicles for business. The corporation should reimburse the employee for his or her business related operating costs, including depreciation. The reimbursement is deductible for the corporation and not counted as income for the employee.

EXAMPLE: Ralph's C corporation, Chrome Dome, Inc., which manufactures head wax for bald men, reimburses Ralph \$3,812 for his costs of driving his new Infinity passenger car on sales calls. Chrome Dome also pays Ralph \$3,060, the amount of first-year depreciation allowed (2011). Total reimbursement to Ralph by the corporation is \$6,872.

Ralph's auto log shows he uses the Infinity 80% for business. So, Ralph reports 20% of the total corporate payments, \$1,374, as income on his personal tax return. Depending on Ralph's tax bracket, the added tax won't likely add more than \$450 to his tax bill. Considering the real costs of owning a nice car, the tax addition is a bargain.

Other Vehicle-Related Deduction Opportunities

Expenses for special commuter vehicles, vehicle taxes, and loan interest can yield more tax deductions:

- **State vehicle taxes.** Whether they're called a vehicle license fee or registration and tag fees, taxes for cars and trucks are deductible. If the vehicle is used strictly for business, then it's a 100% deduction; otherwise, it's according to the business/personal proportion of use (for example, 80% business/20% personal).
- **Special commuter vehicles.** If your business has a vanpool or similar large SUV or minivan that holds at least six passengers, you might be eligible for a tax deduction for commuting expenses. The rules are restrictive, however, and the law forbids a corporate shareholder to be the driver.
- **Loan interest.** If you're using the actual expense method, interest on your auto loan is deductible in proportion to the business use of the vehicle. For instance, if you pay \$1,000 annually in interest on your car loan and you use the car 60% of the time for business, you can take a \$600 interest deduction.
- **Alternative fuel vehicle credit.** You may take a 10% tax credit of up to \$4,000 for the cost of an alternative fuel vehicle (such as natural gas and electric cars), for vehicles purchased or placed in service before January 1, 2011. It will be up to Congress to decide whether or not to extend this credit for the 2011 tax year and beyond. Check the IRS website for updates.
- **Hybrid vehicle credit.** You can claim a tax credit ranging as high as \$3,400, depending on the model (see www.irs.gov for more information). This credit expired at the end of the 2010 tax year but could be extended

by Congress for 2011. Check the IRS website for updates.

How and Where to Claim Expense Deductions

How and where you claim expense deductions depends on what you are deducting and your business entity type (sole proprietorship, partnership, limited liability company, or corporation).

Sole proprietors. Solos, independent contractors, and statutory employees report most business operating expenses on Schedule C of their individual tax returns. (Chapter 7 has a filled-in sample of Schedule C.) See Chapter 5 for information on statutory employees.

S corporations, partnerships, and limited liability companies (LLCs). These businesses file their own tax returns listing expense deductions. S corporations file Form 1120S, partnerships file Form 1065, and LLCs file Form 1065. Each of these entities also issues each shareholder, partner, or LLC member a Schedule K-1 form showing each individual's share of the business's profits and losses. (Chapter 10 has a filled-in sample of Schedule K-1.)

Nonowner/employees. Employees can deduct their out-of-pocket business expenses as unreimbursed employee expenses on Schedule A of their individual tax returns. (Taxwise, it's better if the business reimburses these expenses to the employee.)



TIP

Are you missing paperwork to substantiate your deductions? Throughout the book, you'll read about keeping records to back up business deductions. If you can't find the proper documentation, you might be able to claim a deduction using several "escape hatches." First, business expenses of less than \$75 each don't require written proof to be deductible

(except for lodging expenses). Second, missing documents may be “reconstructed” if you are ever audited. (See “Preparing For Your Audit” in Chapter 20 for details.)

Commonly Overlooked Business Expenses

Even though most small business owners keep a sharp eye out for deductible expenses, it's easy to miss some. And some folks don't list a deduction because they can't find what category it fits into. Some commonly overlooked deductions include:

- sample giveaways and promotions
- CDs and DVDs related to business
- bank service charges on business accounts
- business association dues
- business gifts to employees and customers under \$25
- business publications and books (like the one in your hand)
- casual labor, independent contractors
- casualty and theft losses
- coffee and beverage service
- commissions
- consultant fees
- credit bureau fees
- environmental clean-up costs
- magazines for your waiting room
- Internet service for your waiting room
- website development and maintenance
- parking and meters
- petty cash funds used for minor items
- postage and shipping
- tips and gratuities
- outplacement service fees
- photography
- taxi and bus fare, and
- telephone calls away from the business.

Some of these items are discussed in more detail in this book. And don't forget to claim a 50% deduction for self-employment taxes on the first page of your tax return.

Business Expenses That Aren't Deductible

- Capital expenses (see Chapter 3 for rules on deducting business assets)
- Federal or state income, gift, and estate taxes
- Lobbying and political contributions
- Hobby losses
- Business clothing (unless it qualifies as a uniform)
- Social club dues
- Commuting costs (with a few exceptions)
- Fines and penalties for violations of law
- Business gifts valued at more than \$25
- Personal expenses unrelated to any business purpose.

What Is—And Isn't—Income

“Except as otherwise provided ... income means all income from whatever source derived.” That's how the tax code defines income. (IRC § 61.) Not too helpful, is it? Paraphrased, it means, “You make it, we'll tax it.” It can't get much broader than that.

Things That Count as Taxable Income

For the most part, Uncle Sam doesn't care whether your income is from self-employment, wages, investments, or organized crime. If it's income, it is taxable.

First, anything of value received by you or your business is income *unless* it falls within the exclusions created by Congress. Here are some common noncash sources of taxable income.

Barter or trade. Goods and services received in a business deal are income unless they are consigned to you. When you barter (trade your goods or services), the fair market value of the item or service received is income.

EXAMPLE: Marvin designs a brochure for Beeline Mortgage Brokers, for which he would normally charge \$500. In return, Beeline gets Marvin a new home mortgage without charging its customary \$500 fee. No money changed hands, but both Marvin and Beeline should report \$500 income.

A lot of bartering goes on with small businesses and self-employed people, and the IRS is none the wiser. But getting away with something doesn't make it legal, does it?

Side jobs. You can have business income even if you aren't involved in a money-making activity on a regular or full time basis. If you performed a service and got paid for it only once during the year, it's still income and reportable to the IRS.

Constructive income. Constructive income is a legal doctrine that taxes things that you don't actually have in your hands, but that you have a right to. Whether you grab it or not, it's income the moment it's available.

EXAMPLE: On December 1, 2011, Raylene gets a \$5,000 check from BigCo for her Web design services performed in November. Raylene looks at her books and sees she has already made so much in 2011 that this \$5,000 will be taxed at the highest individual tax rate (35%). Raylene is planning on taking a lot of time off traveling the following year, and her income will be drastically reduced. She would like to hold off cashing the check until after January 1, 2012 so that she can be taxed at a lower tax rate. Can she do it? No. The \$5,000 was constructively received in 2011, and so is income in that year, regardless of when she cashes the check.

Illegal and off-the-books income. The tax law is morally neutral, not distinguishing between the fruits of your labor or ill-gotten gains, so even dirty money is taxable. As the IRS is fond of telling us, the legendary Al Capone wasn't sent to

jail for murder, bootlegging, or racketeering. He went to Alcatraz for not reporting income from all those activities.

EXAMPLE: Rico is a hit man for the Soprano family. The cash, Cadillac, suits, and Cuban cigars he receives for his "work" are all taxable, and reportable, income.

Also in this category are kickbacks and bribes. You don't have to list the source of your illegal income for the IRS—you can claim your constitutional right against self-incrimination. If this sounds like something you might try, see a tax attorney first.

Foreign income. Income you receive from anywhere in the world is taxable for American citizens and most residents, with two exceptions noted below.

EXAMPLE: While traveling in Hong Kong, Juliana, an antique dealer from California, spotted a rare Ming vase. She paid \$200 for it and sold it to another dealer in Hong Kong for \$4,800. Result: Julia must report \$4,600 of taxable income to the IRS. Silver lining: If the primary purpose of the trip was for business transactions like this one, Juliana should be able to deduct at least some of her travel expenses.

Exception one: An American residing out of the U.S. for most of the year can exclude \$91,500 (2011) from his or her income taxes. To get this foreign tax exclusion, you must file a tax return in the United States every year claiming the exclusion.

Two additional key points:

- You must still pay Social Security tax on all your foreign earnings.
- You must pay income tax on any investment income you make while living outside the country.

EXAMPLE: Charlene works as an English teacher in Spain for two years and earns \$45,000 per year. She moves to Spain, not returning to her home in Vermont until three years later. Charlene pays Social Security tax but doesn't owe any income tax in the United States because she files a return each year and gets the exclusion. (This doesn't mean that Charlene doesn't pay taxes in Spain, though.)

Exception two: If you pay taxes in another country on income not covered by the \$91,500 exclusion, you may get a tax credit in the United States for the taxes you paid abroad.

EXAMPLE: Stanley, a Texan, goes to Norway for three months to extinguish an oil fire on an offshore rig in the North Sea. He is paid \$100,000 for the job and pays \$40,000 to the Norwegian government in income tax. Tax result: The \$100,000 is taxable income in the United States too, but Stanley gets a tax credit for the \$40,000 he paid to Norway.

For more info on these two exceptions, see IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

Finally, even if you renounce your U.S. citizenship and move abroad, you are still subject to U.S. tax law on income and gains for ten years. So much for off-shore tax havens.

Exclusions: Things That Aren't Income

Some income isn't taxable because it falls into the "except as otherwise provided" section of the tax law. (IRC § 61.) Here are the main legal exclusions—things that don't have to be reported to the IRS.

Gifts and inheritances. Income tax never has to be paid by the recipient of gifts or inheritances, no matter how much is received.

EXAMPLE: Aunt Sophie leaves Ralphie, her favorite nephew, her mansion on Maui, her Kentucky Derby-winning horse, and \$70 million. Tax result: Ralphie owes nothing to the IRS—but Aunt Sophie's estate most likely paid a hefty estate tax.

Prizes and lottery winnings aren't considered gifts, and are taxable.

EXAMPLE: The Publisher's Clearing House Prize Patrol drops off a \$10 million check at Mallory's house. This windfall is not a gift, since Mallory had to do something for it: fill in the form, place about a hundred different stickers on it, and mail it in. Uncle Sam is due his share of the \$10 million.

Fringe benefits. Many fringe benefits provided by businesses to owners and employees are not taxable income, but a few are. (See Chapter 15.) Bonuses, vacation pay, and the like are always taxable.

Return of capital. Getting back what you put into a business doesn't have any tax consequences.

EXAMPLE: Elaine decides to move to New Zealand and sells her partnership interest in the Doggy Donut business to Marina for \$15,000. She had owned a share of the business for only a few months and had \$12,500 invested in it. Tax result: Elaine must report \$2,500 of income (the gain on her investment in the partnership) on her tax return.

Loans. If the business has to pay it back, it's not income.

EXAMPLE: Roxanne pays \$40,000 for the small warehouse building she uses to store and ship costume jewelry. She refinances the building and takes out a mortgage of \$30,000. This is a tax-free way for Roxanne to take money out of her business.

Consignments. Goods held by your business that belong to others are neither income nor inventory.

For more details on exclusions from income, see IRS Publication 525, *Taxable and Nontaxable Income*.

Deductible Business Expenses and Income in a Nutshell

- Almost any expenditure that is ordinary and necessary for the production of business income is deductible.
- Some expenses are immediately deductible and others must be depreciated, or spread out, over future years.
- The IRS is always looking out for personal costs being included as deductible business expenses (such as entertainment, travel, and vehicle deductions).
- Vehicle and local travel expenses can provide major deductions using either the standard mileage rate or actual expense method.
- Retirement plans provide major tax deduction opportunities for businesses.
- Business related entertainment is 50% deductible.
- Business travel expenses are 100% deductible, except for meals which are only 50% deductible.
- Business bad debts are deductible—but not services provided and not paid for.
- Your costs of going into business are deductible under special rules.
- Some things aren't income, including gifts, inheritances, certain fringe benefits, loans, and returning capital.

Resources

- IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*. This 50-page booklet is a must-read if you are doing your own tax preparation and need more details than we can provide here.
- IRS Publication 525, *Taxable and Nontaxable Income*.
- IRS Publication 529, *Miscellaneous Deductions*.
- IRS Publication 535, *Business Expenses*.
- *Master Tax Guide* (Commerce Clearing House). A one-volume tax reference book with a lot of tax deduction materials for individuals and small business owners. Many IRS auditors use this book for quick answers to tax questions, too.
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs). A good small business guidebook, written by a CPA, that has tips on maximizing deductions.
- *Deduct It! Lower Your Small Business Taxes*, by Stephen Fishman (Nolo). A comprehensive guide to deductions for small businesses.
- Small Business Development Centers (SBDCs) have small business tax publications and personal counseling available. Go to www.sba.gov/sbdc to find an SBDC near you.
- IRS Publication 1542, *Per Diem Rates*.
- IRS Publication 334, *Tax Guide for Small Businesses*. This booklet explains federal tax laws that apply to sole proprietorships.
- IRS Publication 225, *Farmers' Tax Guide*. This publication identifies the kinds of farm income and different deductions peculiar to agricultural activities.

Writing Off Long-Term Business Assets

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“Of all debts, men are least willing to pay the taxes.”

—Ralph Waldo Emerson

One of the few joys of spending money on a new computer, a photocopier, or even that great rosewood desk for your office is knowing that the government is paying part of the cost—maybe as much as 40% or 50%—through tax write-offs.

As a business owner, you are allowed to deduct money you spend on equipment, buildings, or other long-term assets that you use for your business. However, unlike current business expenses that are fully deductible in the year they are incurred, money you spend on capital assets (capital expenses) must be deducted over a number of years through a process known as depreciation.

With depreciation, you write off—recover the cost of—the item by taking tax deductions over a number of years. The idea is that, through the deductions, you recover the cost of the fixed asset as it wears out. (IRC §§ 167 and 168.) How many years it takes to recover the cost depends upon which category of the tax code the asset falls into. It may be as few as three years or as many as 39 years; the IRS makes that determination.

Section 179 of the tax code is an important exception to the regular depreciation rules for long-term assets. This provision lets you immediately write off many capital expenditures, up to a maximum of \$500,000 (2011).

This chapter explains how to best use the depreciation rules and Section 179 to lower your tax bill. Let’s find out how.

Tax Treatment of Business Costs

All business expenditures are divided into two categories: current expenses and capital expenses. Let’s look at the difference between the two.

Current Expenses

Generally, the cost of things that are used up within one year is a current expense. This includes the ordinary costs of operating a business, such as rent, equipment repairs, and telephone and utility bills.

Garden-variety supplies, such as stationery and postage stamps, are also considered current expenses, even though they may be around from one year to the next. You can deduct the cost of these items in the year in which they are purchased. (See Chapter 2.)

Capital Expenses

Capital expenses, on the other hand, are costs you incur for long-term assets—things with a useful life of more than one year. Some examples of long-term assets include equipment, vehicles, and buildings.

A capital expense may be to acquire an asset or to improve one in a way that substantially prolongs its life or adapts it to a different use. (See “Is It a Current or Future Year Expense?” in Chapter 2, for more on how to determine whether improvement costs should be categorized as current or capital expenses.)

Here are some of the more common long-term assets that must be depreciated over a number of years:

- buildings
- cellular phones and beepers*
- computer components and software*
- copyrights and patents
- equipment*
- improvements to business property
- inventory
- office furnishings and decorations*
- small tools and equipment*
- vehicles
- window coverings.*

*May be subject to immediate deduction under Section 179.

You can find out more about items that must be depreciated in Section 263 of the Internal Revenue Code and Regulation 1.263.

Section 179: Expensing Business Assets

You don't need to learn the Internal Revenue Code by section number, but you should know Section 179. This little gem allows businesses to deduct a substantial amount of asset purchases as if they were operating expenses. This produces an immediate write-off of long-term assets.

Using Section 179 is referred to as expensing an asset. Within the annual limit, a business may buy assets and deduct the costs in full—as long as the assets are placed in service in that same year. The Section 179 deduction limit for 2011 is \$500,000 (\$250,000 for remodeling of owned or leased property used for retail business). For example, you can buy new computers, servers, printers, and peripherals for \$82,000 on December 31 and, as long as you start using the equipment that day, you can write off 100% of the cost that year. (A business can spend more than \$500,000 and still get some reduced benefit of the Section 179 expensing provision. See a tax pro for details.)

EXAMPLE: In December, Hal, a self-employed management trainer, realizes he will owe \$4,000 more than the estimated quarterly tax payments he made that year. Hal was planning to buy a \$12,000 color printer the next year. If Hal purchases and starts using the printer by December 31, he qualifies to write off \$12,000 under Section 179 and wipe out all of his tax balance for that year.

It works out like this: Hal is in approximately a 30% combined federal and state income tax bracket and pays self-employment taxes of 15.3%. This means that for Hal's

tax bracket every dollar he takes in business deductions saves him roughly 45¢ in taxes. So the tax savings from the \$12,000 printer purchase (about \$5,000) wipes out Hal's projected \$4,000 tax balance. Of course, Hal had to spend \$12,000 to get the tax savings. As long as he needs the printer, this is still the next best thing to a free lunch. And he could have bought the printer on credit without spending a dime and still have gotten the full write-off for that year.

Section 179 deductions are reported on IRS Form 4562, *Depreciation and Amortization*. (See sample form under "Tax Basis of Business Assets," below.)



TIP

Don't automatically choose Section 179.

When would you not want the fast deduction of Section 179? Answer: When you don't get much, if any, immediate tax benefit from it. Perhaps your business isn't profitable or your income for the year puts you in the 15% tax bracket and you buy a \$30,000 machine on credit. You expect big things to happen soon, which would put you in the 35% tax bracket. By not taking the \$30,000 deduction and using regular depreciation rules, you will save more in taxes in the long run.

Other tax code sections let you choose to expense all assets, similar to Section 179. These special provisions are only for small businesses involved in research (IRC § 174), agriculture (IRC §§ 175, 180, and 193), publishing (IRC § 173), or mining (IRC §§ 615 and 616). (See IRC § 263 and Reg. 1.263 or a tax pro for details.)

Ineligible Assets

For certain types of assets, and in some circumstances, you can't use Section 179's quick write-off. Ineligible property includes:

- real estate
- inventory bought for resale to customers
- anything received by gift or inheritance
- something bought from a close relative—grandparent, parent, child, sibling, or in-law—or from another business in which you have an ownership interest, or
- items you already own. Assets can't be converted from personal to business use under Section 179; instead, they must be depreciated, as explained below.

50% Business Use

To deduct purchases under Section 179, you must use the asset more than 50% for business. For instance, if you use a computer 60% for personal use and 40% for business use, you cannot use Section 179 to write it off—you must use regular depreciation rules (and write off only 40% of the cost).

EXAMPLE: Joan paid \$3,000 for a computer and uses it 60% of the time for business. Using Section 179, she can write off \$1,800 as a business expense (60% business usage × \$3,000 cost).

If Joan used it only 45% of the time for business, she could not use Section 179.

Instead, Joan would have to take depreciation deductions for the portion of the computer used for business (45% business usage × \$3,000 cost = \$1,350) over the five-year period the tax code prescribes for computers.

You must continue to use the Section 179 property in your business at least 50% of the time for several years. The number of years equals the number of years it would have taken to depreciate the items under regular depreciation rules—three to seven years usually. Otherwise, you will have to pay back your prior Section 179 deductions under the IRS recapture rules (see below).

Listed Property—Special Rules

The tax code designates certain assets as listed property, and these items are subject to different rules under Section 179. The most common listed property items include vehicles and computers and peripherals.

Listed property items have a potential for personal as well as business usage, so the IRS enforces strict record-keeping rules for listed property. (See “What Kinds of Records to Keep” in Chapter 4.)

Vehicles. Vehicles used for business can't benefit from using Section 179 (unless they weigh over 6,000 pounds when loaded; see below). The depreciation deduction for vehicles is limited to a certain amount each year—even if you use Section 179. The first-year depreciation deduction is limited to \$3,060 (cars) and \$3,260 (trucks) plus a bonus for 2011 (see “Tax Rules for Business Vehicles,” below). See “First-Year Depreciation Rules,” below, for the limits on depreciation deductions taken after the first year.

For heavy vehicles, such as delivery trucks exceeding 6,000 pounds gross weight when loaded, the depreciation limits don't apply. Instead, there is a Section 179 limit of \$25,000. See “Tax Rules for Vehicles,” below, for details.

Earned Income and Carryforward

Your Section 179 deduction can't exceed your total taxable earnings. However, your earnings aren't limited to the business for which the asset was purchased. You may also count wages that you or your spouse earned as an employee somewhere else (if filing jointly)—or income from other self-employment. For instance, if Sonja's parrot-training enterprise loses money, she can still use Section 179 by taking into account her day job earnings as an undertaker.

If your Section 179 expenditures in one year exceed your total earned income, just carry the

excess over to a future year's tax return. Take the unused deduction every year until it is gone. Tax software can help you keep track.

EXAMPLE: Joy is a sole proprietor with an acting school. After deducting all operating expenses, her earned income is \$6,000. Joy buys \$15,000 worth of stage props using her VISA card. Result: Joy can deduct \$6,000 of the costs using Section 179.

If Joy earns an additional \$9,000 from managing a health food store, she could deduct the whole \$15,000. Otherwise, Joy can carry the \$9,000 unused excess over to her next year's tax return and claim it along with any other Section 179 expenses—as long as she has enough income that year.

Spending Cap

Section 179 is really just for small businesses. The deduction is reduced if you spend more than \$800,000 (2011) on depreciable items, and you lose it altogether if you spend more than \$2,000,000.

Married Couples

Being married can hurt high earners when it comes to Section 179. A married couple is limited to an annual total write-off of \$500,000 (2011). This is true even if both spouses have separate businesses. Even if spouses file taxes separately, each is limited to half of the Section 179 deduction.

In some cases, being married can help if the non-business-owning spouse has other income of his or her own.

EXAMPLE: Paul's Pyrotechnics loses \$70,000 in the same year that Paul purchased a computerized firework launchpad for \$58,000. Polly, Paul's wife, earned \$92,000 that year as a mortgage broker. As long as Paul and Polly

file taxes jointly, the \$58,000 spent on the new launchpad can be written off completely using Section 179. If Paul had not been married, he wouldn't have been able to take any of the Section 179 write-off that year because he had no other income to offset the loss.

Multiple Owners

The Section 179 limit applies to the business as a whole. Partners, LLC members, and shareholders in an S corporation can use the Section 179 deduction in proportion to their ownership interest. With C corporations, only the corporation (not the shareholders) gets the Section 179 deduction.

EXAMPLE: A four-person operation buys \$500,000 of qualified Section 179 equipment in 2011. Each owner can claim one-fourth of the \$500,000 deduction (\$125,000 each) on his or her Form 1040 individual tax return.

Passive Investors

Owners may use Section 179 only if they are active in the business. Passive investors can't use Section 179. However, a passive investor who is employed or active in some other business can use the Section 179 deduction, even if the deduction comes from the business where he or she is a passive investor. The next three examples show how this rule works.

EXAMPLE 1: W & W Partnership buys a \$16,000 injection molding machine for manufacturing plastic toys. W & W allocates \$8,000 of the Section 179 deduction to each of the two partners, Wanda and Willie. If they are both active in the business and earn at least \$8,000 each, they can each claim the full deduction.

EXAMPLE 2: Willie becomes totally disabled in the year W & W Partnership buys the machine. He is still a partner in W & W but no longer works for or gets an income from the partnership. He lives on his Social Security and monthly payments from the state lottery. Willie can't take a Section 179 deduction because he is not active in any business.

EXAMPLE 3: Willie stops working actively in W & W Partnership. He becomes a toy designer for ToyCo and earns \$30,000. He can take his share of the Section 179 deduction of \$8,000 from the W & W Partnership, because he is employed in another business.

Recapture

You must use an asset written off under Section 179 in your business for at least the period over which it would have been deducted had you used regular depreciation. Also, the asset must be used for business at least 50% of all of that time.

If you don't meet these two rules, you face recapture—meaning you have to pay back to the IRS your earlier Section 179 deductions. You have to report the portion of the deduction that would remain if you had depreciated the asset instead of using Section 179.

EXAMPLE: In year one, Hal used Section 179 to write off \$4,000 for a new computer for his business. The amount of depreciation deduction Hal would have gotten if he had used regular depreciation is \$400. The next year, he got a new computer and took the year-old computer home for video games. Hal must report recapture income and give back \$3,600 of the Section 179 deduction in his tax return for that year.

Trade-Ins

The Section 179 deduction is reduced by any trade-in allowance toward the new asset purchase.

EXAMPLE: Rosa buys new showcases for her crafts store, at a cost of \$24,800. She is allowed a trade-in credit of \$9,750 on her old cases, and she pays the difference of \$15,050 on credit. She may claim a Section 179 deduction of \$15,050.

Combining Section 179 and Depreciation Deductions

You can use Section 179 to immediately write off part of the cost of assets and take regular depreciation deductions for the balance.

As this next example shows, it can sometimes be better to not use the full Section 179 deduction.

EXAMPLE: Miranda buys and starts using a \$34,000 instant printing press. Her tax pro tells her that taking the full Section 179 deduction would not produce a tax savings, so she elects to write off only \$10,000 of it under Section 179. She can claim the remaining \$24,000 as depreciation expenses in the following years.

Items Bought on Credit

You can purchase an asset on credit and still get a full write-off under Section 179. This means you can get a tax deduction larger than your cash outlay in that year.

EXAMPLE: With \$10,000 down, Jack buys and starts using \$35,000 worth of machinery for Jack's Tool and Die Shop. He plans to pay the balance of \$25,000 to the seller over the

next five years. Jack is nevertheless allowed to deduct \$35,000 in the year of purchase using Section 179. Also, Jack can deduct any interest he pays on the unpaid balance each year.

Depreciating Business Assets

Profitable small businesses should look first to Section 179 to write off asset purchases. But you must take regular depreciation deductions instead if any of the following are true:

- you don't have enough business or other earned income to offset the Section 179 deduction
- the asset doesn't meet Section 179 qualifications, or
- you've already used up your Section 179 dollar limit that year.

What Is Depreciation?

Depreciation is the loss of value of an asset over time. Almost everything wears out or becomes obsolete. Recognizing this, the tax code gives assets used in a trade or business an annual tax deduction called depreciation. This is commonly called a write-off or cost recovery. For a few special types of assets, this deduction is called amortization or depletion.

To be depreciable, an asset must be:

- owned by the business or the business's owner (leased or rented assets don't qualify)
- used in a business or held to produce income
- have a useful life beyond the year the asset is placed in service (otherwise, it's an ordinary expense item)
- something that wears out, decays, becomes obsolete, gets used up, or loses its value from natural causes
- not subject to any special tax code provisions (such as inventories), and

- not land (Congress has declared that land doesn't become obsolete or wear out).

A depreciation deduction works like this: Derek buys a copy machine for \$1,000 to use in his business. Under the tax code, a copier is assigned a (rather arbitrary) five-year life expectancy. (IRC § 168, Reg. 1.168.) This means Derek can write off part of the cost of the copier in the year he bought it and the rest over the following five years. (Yes, I know this is a total of six years, not five, as the tax code seems to indicate. We'll discuss this further below.) Eventually, the whole \$1,000 cost of the copier will have been deducted from Derek's business income. The amount that Derek can take each year and how the deductions are claimed are explained next.

Keeping Up With Depreciation Rules

Congress changes the depreciation rules frequently—nine times since the 1970s. If the rules change after you acquire something, the old rules still apply. So, you may end up tracking depreciation of different business assets—computers, buildings, or whatever—under several sets of rules. A tax pro can keep the process straight and even compare different depreciation methods available to see which one produces the best result for you. Software such as *TurboTax* (Intuit) also can help track depreciation under multiple schedules.

Depreciation Categories

The tax code establishes depreciation classes or categories for all business assets. Each category is assigned a useful life, meaning the time period over which the cost of an asset can be deducted—for example, five years for a computer. In tax lingo, this is called the recovery period.

IRS Publication 534 lists the categories and the depreciation periods for different assets.

Most assets fit into one of four classes:

- **Three-year property.** Certain types of manufacturing equipment (for example, plastics, metal fabrication, glass).
- **Five-year property.** Cars, trucks, small airplanes, trailers, computers and peripherals, copiers, typewriters, calculators, manufacturing equipment (for apparel), assets used in construction activity, and equipment used in research and experimentation.
- **Seven-year property.** Office furniture, manufacturing equipment (except types included in three- and five-year categories above), fixtures, oil, gas, and mining assets, agricultural structures, and personal property that doesn't fit into any other specific category.
- **Real estate (varying periods).** The tax code dictates much longer periods to write off real estate. This makes sense. Real estate improvements—structures—wear out more slowly than personal property, such as cars and computers. Land itself never wears out, and so is nondeductible and nondepreciable.

Commercial buildings are depreciated over 39 years using the straight-line method (discussed below).

Residential rental real estate is allowed a 27.5-year recovery period.

Some types of land improvement costs (sidewalks, roads, drainage facilities, fences, and landscaping) are depreciable over 20 years.

Some building components, like a special wiring system, may be depreciated in as few as seven years. (For details, see IRS Publication 946, *How to Depreciate Property*.)

There are also classes with ten-, 15-, and 20-year recovery periods for agricultural or unusual businesses, like breeding horses or operating tugboats. See IRC § 168 and IRS Publication 534 for more information on all asset classes, or check with your tax adviser.

Methods of Depreciation

Once you have figured out an asset's depreciation period from the IRS tables, look for the most advantageous depreciation method. Depreciation methods fall into two general types:

- straight-line depreciation, and
- accelerated depreciation.

The tax code has four methods for depreciating most business assets, all of which result in the same total amount of deductions in the end. The difference is in how quickly the complete cost of the asset can be deducted. An additional method, for farm equipment only, isn't covered here. (See IRS Publication 946.)

Straight-line: the slowest and simplest method

The straight-line method allows an asset to be deducted in equal amounts every year, except for the first and last year. (In those two bookend years, you get only half of a year's tax deduction.)

EXAMPLE: Beyonce buys a \$10,000 microscope for researching equine cosmetics. This asset is considered five-year property under the IRS rules. Using straight line depreciation, Beyonce writes off her microscope as follows:

Year 1:	\$ 1,000 (one-half year's depreciation)
Years 2, 3, 4, & 5:	2,000 each year
Year 6:	<u>1,000</u> (one-half year's depreciation)
Total deductions:	<u>\$10,000</u> (cost of the microscope)

First-Year Bonus Depreciation

Small businesses can claim a depreciation bonus deduction in 2011. If you might benefit from a larger-than-usual tax deduction, then read on. If not, you can just stick to regular depreciation rules instead.

In 2011, businesses can deduct immediately up to 100% of the cost of certain business assets acquired and put in use (“placed in service”) that year. This is in addition to any regular depreciation deductions you’re entitled to. The asset must fit into one or more of the following categories:

- tangible property, if it is normally depreciable over 20 years or less (This eliminates such things as patents and copyrights, which are intangible, and most real estate, which must be depreciated over more than 20 years.)
- computer software
- water utility property, or
- interior improvements to certain commercial property and business leases from someone else.

To calculate your deduction, reduce the adjusted basis of the asset by the bonus deduction before computing your regular depreciation deduction for the year. See the example below for how this works.

EXAMPLE: Dionysus, a rock band partnership of musicians, buys four new electric guitars and amplifiers for its band on November 20, 2011. The total cost of the equipment is \$8,000. Dionysus can deduct \$4,000 as a bonus deduction, plus one year’s depreciation on the remaining \$4,000. The regular depreciation amount for the equipment (which is five-year property) is \$400 so Dionysus gets a total \$4,400 deduction.

The first-year bonus depreciation expires at the end of 2011. Congress could decide to extend it for future years. Check the IRS website for updates. These are the basic rules, and there may be further qualifications for your situation. See IRC 168 and talk to a tax pro or visit www.irs.gov before making any decisions.

MACRS: the fastest accelerated method

The accelerated depreciation system is known as MACRS (pronounced “makers”). This stands for modified accelerated cost recovery system.

Technically, MACRS covers all of the accelerated depreciation methods, but it is usually used to refer to the most widely chosen method: MACRS 200% Declining Balance. This is the fastest—most accelerated—way to write off assets (except for Section 179). MACRS allows greater deductions in the early years than in later ones.

EXAMPLE: Beyonce, from the example above, decides to use accelerated depreciation instead of straight-line depreciation for her \$10,000 microscope. Her deductions are:

Year 1:	\$ 2,000	(two times the amount she got using the straight-line method)
Year 2:	3,200	(\$1,200 more than she got using the straight-line method)
Year 3:	1,920	(\$80 less than she got using the straight-line method)
Years 4 & 5:	1,152	(\$848 less than she got using the straight-line method)
Year 6:	<u>576</u>	(\$424 less than she got using the straight-line method)
Total deductions:	<u>\$10,000</u>	(cost of the microscope)

To find the exact yearly deduction amounts, check the IRS tables that show the deduction as a percentage of the asset’s cost. MACRS tables are in your annual Form 1040 instruction booklet, IRS Publication 946, the IRS website (www.irs.gov), and privately published tax preparation guides. Tax software such as *TurboTax* (Intuit) will automatically compute these amounts, too, or you can leave it to your tax pro.

**CAUTION**

The fastest depreciation method may not be the best. Don't automatically conclude that the quicker you can take a deduction, the better. Many start-up businesses are not immediate moneymakers, so they don't benefit by using accelerated depreciation. For them, the straight-line method, with smaller deductions in their formative years, gives the best long-term tax benefit.

Tax Rules for Business Vehicles

There are a number of tax rules just for business-used vehicles.

Annual dollar limits on vehicle depreciation.

Deductions for vehicle depreciation are limited or capped each year. The effect of the caps (called "alternative ACRS depreciation") is to extend the write-off period for newer vehicles, especially luxury cars. First-year bonus depreciation, a special deduction for SUVs, and a tax credit for electric vehicles (all discussed below) are also available for qualifying vehicles. The table below shows the annual depreciation caps for 2011.

**TIP**

Depreciation deductions made easy.

Instead of struggling with the IRS tables, leave it to a tax

pro or do it yourself using tax preparation software like TurboTax.

Sport utility vehicles (SUVs) and light trucks. If you buy a light truck or heavy sport utility vehicle (gross vehicle weight when loaded—GVWR—of over 6,000 pounds), you will not be subject to the annual vehicle deduction limitations. Road yachts such as a Toyota Land Cruiser, Chevy Suburban, Hummer, or Cadillac Escalade, among others, qualify for this special treatment. Lighter SUVs, such as Ford Explorers, Chevy Equinox, and Toyota Highlanders, do not—check the manufacturer's specifications for GVWR.

If your business vehicle falls into this GVWR category, you may either (a) elect Section 179 to deduct in one year up to \$25,000 of the cost of the vehicle, (b) fully write it off in six years using regular depreciation, or (c) use a combination of both provisions.

Electric vehicles. A tax credit for plug-in electric vehicles is available for vehicles placed in service in 2011. Hybrid vehicles do not qualify. Details are available on the IRS website (www.irs.gov).

Using regular depreciation, assuming you use the vehicle 100% for business, here is the amount of depreciation you can take for heavy vehicles:

Depreciation Schedule for Business Vehicles (2011)

Type of Vehicle	First-Year Limit	Second-Year Limit	Third-Year Limit	Fourth-Year and Beyond
Auto	\$3,060 (\$11,060 with bonus)	\$4,900	\$2,950	\$1,775
Truck or van	\$3,260 (\$11,260 with bonus)	\$5,200	\$3,150	\$1,875

Bonus depreciation and the special rules applicable to SUVs and light trucks can cause the amounts to increase greatly in the first year (see explanation below).

These amounts assume 100% business usage. If you use the same vehicle for business and personal use, the figures are reduced proportionately. For instance, if you drive your car 40% of the time for personal reasons, the above numbers are reduced by 40%. So, a second year deduction of \$4,900 for a car would be reduced by 40% from \$4,900 to \$2,940.

Year 1* 20.0 %**	Year 4 11.52 %
Year 2 32.0 %	Year 5 11.52 %
Year 3 19.2 %	Year 6 5.76 %

* You can deduct 20% of the cost of the vehicle in the first year only if you buy the vehicle in the first nine months of the year. If you don't buy it until the last three months of the year, you can take only a 5% deduction the first year.

** See "First-Year Bonus Depreciation," above.

Another tax benefit—big SUVs are exempt from the IRS lease add-backs.

EXAMPLE: Benecia buys a heavy SUV for \$44,000 and uses it 60% for PMC, her successful property management company. The rest of the time Benecia uses her SUV for shopping and camping trips. Her tax basis in the vehicle is \$26,400 ($\$44,000 \times 60\%$ business use). Benecia may use Section 179 to deduct \$15,840 ($\$26,400 \times 60\%$). She can also claim a first-year depreciation deduction of \$1,836 (first-year depreciation of \$3,060 $\times 60\%$), giving her a total Section 179 and depreciation deduction of \$17,676.

Cargo vehicle, minibus, and delivery vans. Vehicles with a GVWR over 6,000 pounds, no seating behind the driver's seat, and a load-carrying design (e.g., a pick-up), may claim up to the full Section 179 write-off (\$500,000 in 2011). Also, passenger vans (over nine-passenger capacity) can claim the full Section 179 write-off.

First-year vehicle bonus deduction. Business vehicles purchased new in 2011 can get a bonus deduction of up to \$8,000 in the first year of use. Choosing the bonus rule (it's optional) increases the maximum \$3,060 deduction to \$11,060 for cars, and from \$3,260 for trucks and vans to \$11,260. Again, these figures are for 100% business usage. If you use your vehicle for pleasure as well as business, you must reduce the deduction amount.

Disposing of business vehicles. Chances are you'll need to get rid of a vehicle that you used for business (and depreciated)—either trading it in for a new one or selling it outright. As you might expect, the IRS has its hand out.

- **Trade-in.** Your tax basis in the new vehicle is increased by the depreciated basis in the old one. The result is that there is no tax gain (or loss) when you trade in. (See "Tax Basis of Business Assets," below, for more.)
- **Selling.** The difference between the (depreciated) tax basis and the sales price produces either a taxable gain or a tax deductible loss. (See "When You Dispose of Assets," below, for details and examples.)



TIP

Deductions with leasing may beat depreciation. Should you lease a business vehicle instead of buying it? Because of the caps and limitations on annual vehicle depreciation deductions, leasing mid-to higher-priced vehicles often provides a larger tax deduction. (See "Leasing Instead of Buying," below.)

Writing off computers and electronics

Ever do work on your computer at home? You can deduct computers you use for business, no matter where they are kept. And you can write the cost off in one year using Section 179. Or, if you choose to write it off over a longer time, the tax code says computers have a five-year depreciable life. You can use either the MACRS or straight-line method to write it off.



TIP

If you use your computer for personal as well as business purposes, keep a diary or log. Record the dates, times, and reason you use your computer to distinguish between personal and business use in case an IRS auditor comes calling. Keep a simple paper pad next to your computer or use your day-timer to keep track of your computer use.

Items not ordinarily tax deductible can be deductible under the right circumstances. I have a great stereo in my home office, and if the volume is cranked up enough, it sounds throughout the rest of the house (to my wife's displeasure). My clients and I enjoy the background music while we ponder their tax problems. It sounds even sweeter knowing that I deducted the entire cost. My home office also contains two aquariums, oriental rugs, and nice furniture which are all deductible because of their business purpose.

EXAMPLE: Herb owns and operates Olde Tyme Quilts, selling quilts that he makes and takes on consignment from other quiltmakers. To improve his skills, he buys and uses a VCR to watch tapes on quilt-making. Later Herb buys a camcorder to make tapes of quilt designs at craft shows, a video catalog of his stock, and himself doing a quilt-making demonstration. These items are all depreciable or deductible under Section 179. But if he also uses the VCR and camcorder for vacations to Hawaii, he must apportion his costs between business and personal use.

You might have to defend your asset purchases at an audit. You are on the honor system when it comes to claiming most business asset purchases—no one from the IRS is watching to see how you really use your camcorder. Just be ready to prove its business purpose. Otherwise, an auditor can reclassify it as a (nondeductible) personal expense.

First-Year Depreciation Rules

Whether you use a straight-line or accelerated depreciation method, the following rules apply.

Asset must be placed in service

Depreciation starts in the year that an asset is placed in service. This means that you must start

using the asset in your business before you can claim a depreciation deduction. So, if you buy equipment in December 2011 but don't take it out of the box until January 2012, you may not take a deduction for it in 2011. You should note the date of first use of an item for your records.

The half-year convention

When during the first year does the depreciation period begin? Generally, assets are treated as if you bought them in the middle of the year—July 1. This rule is called the half-year convention.

Bottom line: You get only six months depreciation deduction in the first year (unless you use Section 179). Your final tax deduction comes in the year after the end of the asset's scheduled life. So the final year of deductions for five-year property, such as a computer, is really the sixth year.

EXAMPLE: Julie buys a color copier to use at her boutique for \$2,000. If Julie depreciates it over five years on a straight-line basis, her annual full-year deduction will be \$400 (\$2,000 divided by five years). Her half-year deduction for the first and the last years is \$200. Here is a schedule of Julie's deductions for six years, at which point the entire cost will have been written off:

Year 1	\$ 200	(half-year convention)
Year 2	400	(full-year deduction)
Year 3	400	(full-year deduction)
Year 4	400	(full-year deduction)
Year 5	400	(full-year deduction)
Year 6	<u>200</u>	(half-year convention)
Total	<u>\$ 2,000</u>	(Julie's cost is fully recovered)

The last quarter limitation

Another tax quirk can further reduce your first-year depreciation deduction. If you make more

than 40% of all your asset purchases in the last three months of a year, you get only 1.5 months of depreciation on the asset purchases made in the last three months. So unless you are using Section 179 to deduct the cost, don't buy equipment near the end of the year if you're looking for the highest deductions.

EXAMPLE: Julie, from the example above, also purchases \$25,000 of new display cases—classified as five-year property—in May. If she uses the straight-line method of depreciation, the tax write-off for the first year is \$2,500 for the cases ($\frac{1}{2}$ year $\times$ \$25,000 $\times$ $\frac{1}{5}$). In November, Julie buys \$20,000 of racks and shelving (also five-year property). Since Julie's November purchase is more than 40% of the total assets bought during the year, she can write off only 1.5 months of 60 months ($\frac{1}{40}$) of the cost of the racks and shelving (\$20,000), which means a first-year depreciation of \$500. So, Julie's total depreciation for equipment in year one is \$3,000.

How to Report Depreciation and Section 179 Deductions

Depreciation and Section 179 deductions are claimed on IRS Form 4562, *Depreciation and Amortization*. Sole proprietors, partners, LLC members, and S corporation shareholders file Form 4562 with their individual returns, and C corporations file it with their corporate income tax returns.

You must file Form 4562 each year if you are:

- depreciating any assets acquired that year
- depreciating certain types of assets (such as vehicles, computers, cellular phones, and a few others named in the tax code) acquired in a previous year, or
- operating as a C corporation and are depreciating any assets.

A sample Form 4562 is shown below. For the latest forms, see the IRS's website at www.irs.gov or call the IRS at 800-829-FORM and request forms by mail.



CAUTION

The sample forms are for illustrative purposes only. Throughout this book we provide sample, filled-out IRS forms. Keep in mind that these forms are just that: examples. Your completed, filled-out tax form will look different. Always check the IRS website to see if there are updated forms, and if you're unsure of how to complete a form, see a tax pro or relevant IRS publications.



CAUTION

Watch out for depreciation recapture.

Depreciation deductions may come back to bite you if you stop using business property. You may have to report income for past tax deductions for depreciation (called recapture) when an asset is no longer used for business.

EXAMPLE: Rusty, a self-employed flooring contractor, closes his shop and sells his Dodge pickup for \$7,500. The truck cost \$11,000, and Rusty took a total of \$4,200 of depreciation deductions in past years (this means his tax basis in the truck is \$6,800). He must report \$700 as recapture income (the difference between his tax basis of \$6,800 and the sale price of \$7,500) on his tax return.



TIP

Show the IRS how you figure depreciation.

While not required, it's a good idea to attach a separate depreciation schedule or worksheet to your tax return whenever you claim depreciation or Section 179 deductions. This shows the IRS how the deduction was calculated and it may ward off a further IRS inquiry or audit. It indicates that you are careful and aware of the tax rules on depreciation. Tax preparation software creates these depreciation schedules and worksheets. Also see our example (below) of a hand-written depreciation worksheet.

Sample Form Showing Where to Claim a Section 179 Deduction

Part
1

The Basics

Form 4562 Department of the Treasury Internal Revenue Service (99)	Depreciation and Amortization (Including Information on Listed Property) ▶ See separate instructions. ▶ Attach to your tax return.	OMB No. 1545-0172 2010 Attachment Sequence No. 67				
Name(s) shown on return Mikela's Mambo Palace		Business or activity to which this form relates Dance School				
Identifying number						
Part I Election To Expense Certain Property Under Section 179 Note: If you have any listed property, complete Part V before you complete Part I.						
1 Maximum amount (see instructions)		1 \$500,000				
2 Total cost of section 179 property placed in service (see instructions)		2				
3 Threshold cost of section 179 property before reduction in limitation (see instructions)		3 800,000				
4 Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-		4				
5 Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions		5				
6 (a) Description of property sound system	(b) Cost (business use only) \$15,000	(c) Elected cost \$15,000				
7 Listed property. Enter the amount from line 29		7				
8 Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7		8 15,000				
9 Tentative deduction. Enter the smaller of line 5 or line 8		9 15,000				
10 Carryover of disallowed deduction from line 13 of your 2009 Form 4562		10				
11 Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)		11				
12 Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11		12 \$15,000				
13 Carryover of disallowed deduction to 2011. Add lines 9 and 10, less line 12 ▶		13				
Note: Do not use Part II or Part III below for listed property. Instead, use Part V.						
Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)						
14 Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)		14				
15 Property subject to section 168(f)(1) election		15				
16 Other depreciation (including ACRS)		16				
Part III MACRS Depreciation (Do not include listed property.) (See instructions.)						
Section A						
17 MACRS deductions for assets placed in service in tax years beginning before 2010		17				
18 If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ☐						
Section B—Assets Placed in Service During 2010 Tax Year Using the General Depreciation System						
(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	
Section C—Assets Placed in Service During 2010 Tax Year Using the Alternative Depreciation System						
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	
Part IV Summary (See instructions.)						
21 Listed property. Enter amount from line 28		21				
22 Total. Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions		22				
23 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs		23				

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form 4562 (2010)

Depreciation Worksheet

Description of Property	Date Placed in Service	Cost or Other Basis	Business/Investment Use %	Section 179 Deduction	Depreciation Prior Years	Basis for Depreciation	Method/Convention	Recovery Period	Rate or Table %	Depreciation Deduction
Computer	3/31/11	3,200	100%	3,200	0	0	200DB/MY	5	20%	0
Cellular Phone	6/26/11	300	40%	0	0	120	SL/MY	5	10%	12
Chevy Pick-Up	11/1/10	10,500	20%	0	525	2,100	SL/MQ	5	20%	420
Total				3,200						432

Inventory

Businesses that sell goods (rather than services) usually maintain stock, called inventory. Money spent on inventory is neither a current expense nor a capital expense. Instead, inventory is an asset and is expensed as it is sold or discarded.

In effect, you deduct what you spend for inventory (called your costs of goods sold) from the revenue generated as the inventory is sold. What's left is your gross profit. From this figure, you deduct your general business expenses to determine your net profit. It is the net profit that is taxed as income.

Valuing your inventory. The higher your cost of goods sold is, the lower your profit—and thus your taxes—will be. For this reason, you must figure your cost of goods sold using an IRS-approved inventory accounting method. Inventory generally must be listed at the lower of its cost or its fair market value. This is also known as book value in accounting terms.

EXAMPLE: During its first year of operation, Rick's Music Store purchased \$300,000 of inventory. At the end of the year, he has an inventory of compact discs that cost \$50,000 and cassette tapes that cost \$30,000. Using the cost method, Rick has an ending inventory worth \$80,000. Here is Rick's cost of goods sold:

$$\begin{aligned}
 & \$ \quad 0 \text{ beginning inventory} \\
 & + \quad 300,000 \text{ inventory purchased during year} \\
 & - \quad \underline{80,000} \text{ ending inventory at cost method} \\
 & = \underline{\$ 220,000} \text{ cost of goods sold}
 \end{aligned}$$

Unsaleable inventory. You may reduce (write down) the book value of any inventory that has become unsaleable. For IRS purposes, this needs to be documented. For instance, if you discard or destroy dead stock, keep evidence of the destruction—photos, videos, receipts, or the statement of a reputable third party who can certify the goods were destroyed. Another option may be to donate inventory to a nonprofit.

EXAMPLE: Continuing with Rick from the above example, at inventory time, Rick knows his inventory of CDs has held its value, but his cassettes hardly sell. Rick asks his music distributor to appraise the cassettes. The distributor says their fair market value is only \$8,000. Accordingly, Rick lowers the inventory on his books to \$8,000. Now Rick's cost of goods sold looks like this:

$$\begin{aligned}
 & \$ \quad 0 \text{ beginning inventory} \\
 & + \quad 300,000 \text{ inventory purchased during year} \\
 & - \quad \underline{58,000} \text{ ending inventory at fair market method} \\
 & = \underline{\$ 242,000} \text{ cost of goods sold}
 \end{aligned}$$

To sum up, the difference between the two examples is the method of valuing the inventory. Using fair market value instead of cost will reduce Rick's net income by \$22,000. With the taxes saved from the inventory write-down, Rick can build up his CD inventory.

Don't reduce the book value of the inventory without clear evidence of the loss in value and without reducing the retail price of the goods.

Manufactured goods. Like sellers of goods, manufacturers of goods often maintain an inventory that they value at the beginning and end of each tax year. From this valuation, they determine the cost of goods sold for the year. They deduct the cost of goods sold from their gross receipts to arrive at their gross profit for the year. Unlike sellers of goods, manufacturers can include manufacturing costs into their cost of goods sold.

The most common expenses included in the cost of goods sold by a manufacturing business are:

- the cost of the raw materials, including freight
- storage
- direct labor costs (including contributions to pensions or annuity plans) for workers who produce the products, and
- factory overhead.

Certain manufacturers are subject to more complex accounting, such as the uniform capitalization rules. For additional information, see a tax pro or IRS Publication 334, *Tax Guide for Small Businesses*, and the chapter on inventories in IRS Publication 538, *Accounting Periods and Methods*.

Tax Basis of Business Assets

Tax basis, or just plain basis, is the amount the tax code says you have invested in an asset—which may be quite a different figure from what you think.

Your basis in an asset determines how much you can deduct each year for it. Basis is also used

to determine your taxable gain or loss when you sell or dispose of the asset.

The basis of a business asset will change over the period that the asset is in use. This is known as “adjusted basis.” The basis is adjusted upwards for certain additions such as improvements to property, and downwards for depreciation deductions.

IRS Publication 551, *Basis of Assets*, provides a detailed explanation of the law on basis (available at www.irs.gov).

Purchased Items—Cost Basis

Generally, the beginning tax basis of an asset is what you paid for it. (IRC § 1012.) So, if Billie Bob pays \$3,000 for a dry cleaning machine for his store, Clean World, that's his beginning basis. Related costs, such as \$200 for freight to get it to Clean World and \$150 for installation, are added to the beginning basis, making it \$3,350.

Basis also includes state and local taxes (meaning you can deduct any use or sales-type taxes you pay along with the item itself). These taxes become part of the basis of the asset and are depreciated over time with the asset. For instance, an 8% state sales tax on a truck purchased for \$10,000 (\$800) must be added to the truck's basis (\$10,800) and written off over the period the truck is depreciated, usually six years.

Items Received as a Gift—Transferred Basis

If you receive something as a gift, you take the same tax basis as the person who gave it to you. This is called a transferred basis. (IRC § 1015.)

EXAMPLE: Ralph's father, Josiah, gives him a building worth \$60,000. Josiah's tax basis in the property was \$15,000; Ralph has a transferred basis the same as his father's: \$15,000. So if Ralph immediately sells the building for its fair market value of \$60,000,

he will owe tax on a \$45,000 gain (the sales price, \$60,000, less his tax basis, \$15,000).

Items Received for Services—FMV Basis

If you receive something in exchange for your services, your basis is the item's fair market value. (IRC § 7701.) The value of the asset is taxable income. If the asset is then used in your business, it may be deducted under the depreciation rules.

EXAMPLE: Woody refinished four antique chests for Zeke; in exchange, he received one of them. Because it could be sold for \$250, its fair market value was \$250, which became Woody's tax basis in the chest. Woody should report \$250 as income on his tax return that year. When Woody sells the chest for \$350 two years later, he has a further taxable gain of \$100 (less any costs of making the sale, such as a newspaper classified ad).

Items You Inherit—Step-Up Basis

If you inherit something and put it to use in your business, the tax basis of the item is its fair market value on the date of death of the person who left it to you. (IRC § 1014.) That might mean a big tax break when you sell. This is because your taxable profit is based on the date-of-death value, which could be considerably more than the former owner paid for it. This is referred to as a step-up in basis and is most common with inherited real estate.

EXAMPLE: Beth dies and leaves a warehouse to her son, Charles. She bought the property in 1970 for \$50,000, and it was worth \$200,000 on the real estate market when Beth died. When Charles inherits the warehouse, his stepped-up basis in it is \$200,000.

Charles, who has an insurance agency, can't use the warehouse, but needs a small office building for his business. Charles sells the warehouse for \$200,000. He has no taxable gain or loss, because \$200,000 was his tax basis. Charles can then buy a new building for his agency with the proceeds and begin taking depreciation deductions.

Items Exchanged for Other Items—Substituted Basis

If you trade an asset, the basis of the newly acquired asset is usually the same as the property you traded. This is called substituted basis.

EXAMPLE: Janet, a cabinetmaker, trades a table saw with a tax basis of \$250 to Boffo for his industrial shop vac. Her basis in the shop vac is \$250.



CAUTION

The exchange must be for like kind property to be nontaxable. For instance, if you trade away real estate, you must receive real estate in exchange. And if you trade tangible property (such as Janet's table saw, above), you can't get intangible property, such as a copyright, in return.

If you trade different types of things, the tax code says this is a sale of one item (normally resulting in a taxable profit), followed by the purchase of another item, and not a tax-free exchange of like kind property.

Items Exchanged for Items and Money

If you trade something and throw in money to boot, your basis in the newly acquired property equals the basis of the asset you exchanged plus the amount you paid in cash—called boot in tax lingo.

EXAMPLE: Kevin trades his old Ford (tax basis of \$3,000) and \$10,000 cash (the boot) to Truck City for a new Chevy. Kevin's basis in the new truck is \$13,000.

Conversely, if you receive an asset plus money, your basis in the item is reduced by the amount of the cash.

EXAMPLE: Ken trades his Hummer with a basis of \$50,000 for a Dodge pickup and \$40,000 in cash. Ken's basis in the Dodge is \$10,000.

Items Converted to Business Use

When you convert personal, nonbusiness assets to business use, you must determine their basis at the time you make the switch. The tax basis of converted property is the lesser of:

- the fair market value of the asset on the date you convert it to business use, *or*
- your adjusted basis in that property. (IRC § 167.)

EXAMPLE 1: Jacob bought a \$2,500 computer a year ago for fun and games, but now starts using it in his snowboard shop. The tax basis of the computer is the lesser of Jacob's cost or its current fair market value. Jacob finds its fair market value is now \$1,000, which becomes its tax basis as a business asset.

EXAMPLE 2: Theresa pays \$60,000 to have a home built on a lot valued at \$10,000. She lives in the home five years and spends \$20,000 for improvements. One year Theresa claims a \$2,000 tax deduction for a casualty loss when a runaway car hits her living room. Over time, Theresa's house comes to have a fair market value of \$125,000. Theresa moves out and converts the house into a health food store. The tax basis of the converted building is computed as follows:

$$\begin{array}{rcl}
 & \$ & 60,000 \text{ cost to build home} \\
 + & & 20,000 \text{ improvements over the years} \\
 - & \underline{\hspace{1cm}} & 2,000 \text{ deduction taken for casualty loss} \\
 = & \$ & \underline{78,000} \text{ tax basis at time of conversion}
 \end{array}$$

(The \$10,000 cost of the land is not part of the basis of the building; as land, it is never depreciable under the tax code.)

Theresa must use \$78,000 as her tax basis because it is less than the fair market value of \$125,000, according to the tax rule discussed above. (IRC § 167.)

EXAMPLE 3: Going back to Theresa's situation, if the building's fair market value had decreased to \$50,000 at the time Theresa converted it to business use, her basis would be \$50,000. That's because she must use the fair market value as her basis whenever it is lower than her adjusted basis. (IRC § 167, Reg. 1.167.)

Leasing Instead of Buying

If you need vehicles for your business, consider leasing instead of purchasing. You can deduct your vehicle lease payments as current business operating expenses, although some special tax rules apply to lease deductions. Leasing can provide large tax deductions, oftentimes resulting in a better tax benefit than the depreciation deductions you would get from purchasing a vehicle. If you're considering leasing versus buying, consult with a tax pro.

Vehicles Used for Business

Both tax and nontax considerations determine whether it's best to buy or lease a car or truck for your business. Here are some tax angles to consider.

Keeping track of personal use

Many business owners, particularly owners of small businesses, use their car for both business and personal purposes. If you do this, you must keep track of your business and personal use. This is true whether you lease or own your vehicle because, either way, you must prorate your time between personal and business use to calculate your tax deduction.

You can find a simple logbook to keep track of your use at office supply stores or get one from a tax pro. You can also use a spiral notebook or something more high tech like a BlackBerry—whatever you're comfortable with that works.

Leasing often means greater vehicle deductions

The lease versus buy deduction decision is often complex, as you will see. Before springing for that new car or truck, you may want to have a tax pro do the analysis for you.

The main reason leasing is often a better tax deal is that, unlike buying, lease payments are fully deductible. This assumes your business use is 100%. If you use your vehicle less than 100% for business, you must reduce the deduction proportionately.

EXAMPLE: Rajesh has a leased Porsche that he used 63% for business over 12 months. His annual lease payments total \$10,000. To figure his tax deduction, he must reduce the \$10,000 in payments by the percentage of his personal use, or 37%. This reduces his deduction to \$6,300. But, it's not over yet. There is one more step—the lease inclusion rules.

IRS lease inclusion tables

You must offset your lease deductions by an inclusion amount set by the IRS. This required offset only applies to passenger cars that cost more

than \$16,710 and trucks and vans that cost more than \$17,000 (2011).

The inclusion amounts can be found on IRS tables in IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*. In effect, the inclusion slightly reduces the tax benefit of the lease payments, especially for luxury vehicles. If you're using a tax preparer or a software programs like TurboTax, you don't have to dig through the lease inclusion tables.

EXAMPLE: Phil, an independent representative for Higher Point Furniture, leases a \$71,000 BMW for 60 months. If Phil used the car 100% for business, he would deduct all of his \$780 per month lease payments as current business expenses. Under the lease inclusion tables, Phil must report \$374 additional inclusion income for the first year of the lease. The amount rises each year until it is \$1,689 in the last year of the lease. But this is still a great deal for Phil. Even if he were in the very highest federal and state tax brackets, the added tax would range from about \$180 to \$800 per year. If Phil's business use was less than 100%, then the inclusion amount would be reduced accordingly.

The IRS inclusion tables are adjusted annually for inflation. Tax pros and tax software programs, like *TurboTax*, can easily make the lease inclusion calculations for you.

A further consideration in weighing a lease versus a purchase is the tax benefit you get from your car loan interest payment deduction. If you buy a car and pay \$2,000 in interest over a year and drive it 80% for business, \$1,600 of the interest is deductible as a business expense. (The other \$400 is nondeductible personal interest.)

An alternative way to deduct leased vehicles

Instead of deducting lease payments, you may elect to use the mileage method for leased vehicles. The

IRS deduction rate is 51 cents per mile for the first half of 2011 and 55.5 cents per mile for the second half of the year (July 1 through December 31).

However, once you start using the mileage method, you must continue to use it for the rest of the lease. Before choosing, estimate your annual business mileage and compare the tax deduction allowed under the mileage method with the amount under the regular lease deduction rules.

As a rule of thumb, with lower-cost leased vehicles like Honda Civics, Toyota Corollas, and similar cars driven 15,000 or more miles a year, the mileage method might be best. If you lease, look at both using the mileage method and deducting the lease payments. You don't make this decision until after the end of the first year, and tax software (like *TurboTax*) makes this fairly easy.

End of the lease

Leasing avoids potential taxable gains from depreciation recapture when you dispose of an owned car or truck. That's because turning in a leased car is a nontaxable event. If you decide to purchase the car from the lease company, you can then start taking depreciation deductions (as explained in Chapter 2).



CAUTION

Whether to lease or buy should not be just a tax decision. First, do a purely economic analysis of the lease. Start with the stated gross capitalized cost (value or purchase price of the vehicle). Then find the stated residual value (what the car will be worth) at the end of the lease. Next, use a buy versus lease calculator (check the Internet—many car sites have these kinds of programs) to compare the costs.

While leasing contracts are harder to figure out than purchases, they can produce big tax savings by allowing larger deductions.

All leases limit the total miles you can drive and all penalize you for terminating the lease early. Manufacturers frequently have the best lease deals, so start there. Never rely on a car salesperson for advice

on lease or own. Salespeople push leases because they get higher commissions; dealers like leases because they can disguise the true sales price in the lease agreement mumbo jumbo.

Leasing Your Assets to Your C Corporation

A business doesn't have to own all of its operating assets. Leasing your personally owned property—your building, vehicle, or equipment—to your C corporation may provide a tax savings.

Alternatively, an asset leased to your C corporation may be owned by another corporation, a partnership, or a family business in which you have an ownership interest. (As discussed in Chapter 13, such arrangements can result in income shifting—transferring income to people in lower tax brackets to reduce overall taxes for the family unit.)

To pass IRS scrutiny, leases between an individual and his corporation must be arm's length deals, not merely tax-motivated schemes—this means the terms must be commercially reasonable.



TIP

Leasing assets protects owners from business creditors. Apart from taxes, shareholders—especially in endeavors where lawsuits are a hazard—don't want their corporation to hold substantial assets. Leasing insulates the assets from potential creditors of the corporation.

Lease payments are deductible for the corporation. Lease income is taxable to the asset's owner, who in turn deducts costs of ownership—mortgage interest, property taxes, maintenance, repairs, and depreciation. The overall result may be a tax wash—no money savings—but might work, as the following example shows.

EXAMPLE: Sam bought a store building in June 2011 for \$100,000. The land has a fair

market value of \$20,000, and the structure a fair market value of \$80,000. Sam does some minor repairs and leases the building to Sam Smith, Inc., a C corporation, in 2012 for \$16,000 per year. Sam's out-of-pocket expenses of ownership are \$15,000, and he is entitled to a \$2,052 depreciation deduction in 2012 (the second year's write-off of the building as allowed in the tax code). Tax result: Sam is ahead \$1,000 in cash after expenses (\$16,000 – \$15,000). This is canceled out by his \$2,052 depreciation deduction. Sam has a tax loss of \$1,052. This paper loss can shelter some of Sam's other earned income in 2012, such as his salary from Sam Smith, Inc. Before setting it all up, Sam sat down with his tax adviser—and so should you.

When You Dispose of Business Assets: Depreciation Recapture

At some point, you'll no longer need a business asset, whether it's a vehicle, a machine, or an office building. Things wear out, become obsolete, or no longer fit.

You claimed annual depreciation deductions for the asset, and may even have written it off 100%. Uh, oh—the disposition might trigger tax payback, or recapture. Let's look at the rules here for all (noncorporate) businesses. IRC § 1231 and IRC § 1245 are the two guiding tax code provisions.

Business asset dispositions are reported to the IRS on Form 4797, *Sales of Business Property*. Sole proprietors may also need to report the gain or loss on Schedule D of their individual tax return. (See Chapter 16 for details.)

Sale of Business Equipment

Selling is the most common way to get rid of an unwanted business asset. What are the tax consequences?

Gain triggers depreciation recapture tax

Any gain you make over your tax basis in the asset is taxed. Your tax basis is figured by subtracting the depreciation deductions you've taken on it from what you have invested in it.

EXAMPLE: Bonnie sells a 20-foot custom teak conference table that doesn't fit into her new law office. She paid \$10,000 for it, and over several years took \$8,000 in depreciation deductions. Her tax basis is \$2,000. Bonnie sells it to Regina for \$2,500. Tax result: Bonnie owes income tax on \$500 (\$2,500 – \$2,000), the gain the tax law says she had after the recapture of previously claimed tax deductions.

Recapture taxed at ordinary income tax rates

If a gain on a sale is all from the recapture of depreciation deductions, it is taxed at ordinary income tax rates and not at lower capital gains tax rates. This is true no matter how long the asset has been held.

EXAMPLE: Returning to Bonnie's situation, her \$500 gain represents a recapture of depreciation deductions taken in past years. If Bonnie's individual income tax rate is 25%, her income tax on the gain from the sale of the desk is \$125. Depending on her state of residence, Bonnie may owe state income taxes as well.

Gain other than recapture may be taxed at a lower rate

If a business asset is sold for more than the total depreciation deductions taken in past years, the tax is figured at the Section 1231 tax rate. Generally, this means a tax rate lower than the

ordinary income tax rate for an individual. In 2011, the Section 1231 tax rate ranged from 0% to 15%, depending on the taxpayer's income bracket. Some non-business assets, such as collectibles, are not eligible for this lower tax rate. (See IRS Publication 544, *Sales and Other Dispositions of Assets*, for details on how this tax calculation is made.)

EXAMPLE: Let's say Bonnie, from the examples above, sells the table in 2011 to Regina for \$12,500. Remember, Bonnie's original outlay was \$10,000. Her tax basis was \$2,000 because she took \$8,000 in deductions over several years. Tax result: Bonnie is treated as having a \$10,500 taxable gain on the sale. Out of Bonnie's gain, \$8,000 is attributable to depreciation deduction recapture and is taxed at her ordinary income tax rate of 25%. But the remaining \$2,500 is taxed at the special Section 1231 tax rate, which in her case is 15%. Her capital gain tax is \$375 ($\$2,500 \times 15\%$).

Like-Kind Exchanges

Like-kind exchanges avoid depreciation recapture. You simply trade in a business asset for another one with no tax consequences, unless you receive money in exchange. In that case, you'll need to report that cash received as income. However, the exchange should be reported to the IRS. See Form 8824, *Like-Kind Exchanges*, and the instructions.

EXAMPLE: Rusty, a drywall contractor, trades in his three-year-old small Ford pickup for a new full-sized Chevy truck. Rusty also pays the dealer \$10,000. No matter how much depreciation Rusty took on his Ford in the past, he won't have any taxable gain (or loss). This is a like-kind exchange of business assets.

Destroyed or Stolen Assets

If a business asset becomes damaged, destroyed, or stolen, the tax code calls this an involuntary conversion. If the loss is fully reimbursed by insurance, there is no tax consequence as long as the insurance proceeds are used to replace the asset. The involuntary conversion avoids depreciation recapture.

EXAMPLE: Rusty, in the example above, wrecks the Ford pickup on the way to the Chevy dealer. Allsnake Insurance declares the truck a total loss and pays him \$9,000. This is \$2,200 more than Rusty's tax basis in the Ford, which would normally mean he would owe income tax on a \$2,200 gain from recapture of depreciation. But, if Rusty buys the Chevy for at least \$9,000, there's no taxable gain.

Sale of Real Estate

If your business sells or otherwise disposes of real estate that was depreciated in prior years, special tax recapture rules apply. As discussed above, if this property is sold for more than you paid for it, prior depreciation deductions are now taxed at ordinary income tax rates. In some cases, it is possible to defer taxes using Section 1031 if you reinvest in other real estate within a specific time frame.

The income taxation of real estate transactions is beyond the scope of this book. See a tax professional or IRS Publication 544, *Sales and Other Disposition of Assets*, for details on real estate tax rules.

Tax Errors in Depreciation

It's easy to miscalculate your depreciation deductions—a good reason to use a tax preparer or software such as *TurboTax*.

If you catch a mistake after you have filed a tax return, it can be corrected. This could result in a tax refund or a tax bill—depending on which direction the error was made in. Make the correction by filing Form 3115 or Form 1040X, *Amended Tax Return*. It is best to have a tax pro do this for you. If an IRS auditor catches the mistake, it will likely cost you a tax penalty. Final thought:

Writing Off Business Assets in a Nutshell

- All expenditures for business fall into two categories—current expenses and capital expenses.
- Capital assets are items with a useful life of more than one year that are usually written off or depreciated over a period of years.
- To depreciate long-term property, you can use the accelerated or straight-line method—either way, the entire cost of the asset is written off over time.
- Section 179 allows small business owners to currently deduct up to \$500,000 (2011) of long-term business property.
- There are special tax rules for depreciating vehicles, depending on the weight of the car or truck, and whether it is leased or purchased.
- Business asset write-offs are reported annually on IRS Form 4562.
- Your basis in an asset determines your depreciation deduction and your gain or loss on the sale of the asset.
- The sale of a business asset may result in the recapture and taxing of prior depreciation deductions.
- Like-kind exchanges of assets are not taxed (such as trading in a vehicle).

Resources

- IRS Publication 946, *How to Depreciate Property*.
- IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*.
- IRS Publication 551, *Basis of Assets*.
- IRS Publication 544, *Sale or Other Disposition of Assets*.
- IRS website, www.irs.gov. Here you can download the latest tax forms and publications.
- IRS small business website. This is a useful website for the nation's 45 million business and self-employed taxpayers. The site provides:
 - answers to basic tax questions
 - a calendar of tax deadlines for small businesses
 - industry-specific tax info for industries such as construction and food service
 - tips to avoid common tax problems
 - links to court opinions and to rulings and regulations on specific industries
 - links to other websites for general tax information, and
 - links to helpful small business resources.

You can access this site by going to the IRS home page at www.irs.gov and clicking on “Businesses” and then “Small Business and Self-Employed.”
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs). This CPA-written self-help book covers the fundamentals of depreciating business assets and keeping depreciation records.
- *Deduct It! Lower Your Small Business Taxes*, by Stephen Fishman (Nolo). A comprehensive guide to tax deductions for small business owners that covers depreciation rules and Section 179.

“A tax loophole is something that benefits the other guy. If it benefits you, it’s tax reform.”

—Senator Russell Long

Bookkeeping and Accounting

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“The income tax has made more liars out of the American people than golf has.”

—Will Rogers

Most ventures are started by enthusiastic people with ambition. Whether they are hoping to build the next Fortune 500 company or simply supplement their day job, it’s what the business will buy, sell, make, or fix that drives them. They aren’t intrigued by the paperwork, but the law mandates some basic record-keeping know-how. And, in the long run, keeping good records can save you money at tax time.

The good news is that the IRS does not require business records to be kept in one uniform fashion. Any format is okay, as long as it paints a true picture of income and expenses. Since no two enterprises are alike, no two accounting systems are exactly alike.

The first commandment of the tax code is: Thou shalt keep “records appropriate to your trade or business.” (IRC § 6001.) And, of course, they must be accurate. (Reg. 31.6001-1(a).)

This chapter outlines the minimum record keeping required, and tips for setting up an easy system. We’ll also cover some common record-keeping pitfalls and how to avoid them. Never forget that the IRS (and state tax agencies, too) have the right to audit you and inspect your records.

Record Keeping If You Have Several Small Businesses

How do you report income from more than one business on a tax return? Let’s say you are a part-time coin dealer and you own a bicycle shop, and your spouse has a sideline home decorating business. You’ll need three sets of records, because each venture requires separate tax reporting. For instance, three sole proprietorships require three IRS Schedule C forms with your tax return each year. (See Chapter 7.)

Why You Need a Bookkeeping System

Operating without records is like flying in dense fog with no instruments. You may be thinking, “I’ll skip this section; I hate bookkeeping. After all, if my business takes in enough money, all these paperwork matters will resolve themselves. If they don’t, I’ll hire someone to clean them up later.” Think twice, please.

Some fledgling entrepreneurs think that if there is money in their business checking account at the end of the month, they must be making a profit. This may be so, but only by keeping accurate records will you really know if you’re making or losing money.

A record-keeping system is also crucial for preparing your annual tax returns. And last but not least, records are a must should the IRS or state ever come knocking on your door.



CAUTION

Take record keeping seriously. If you get only one thing out of this book, go away knowing that ignoring record keeping is inviting disaster. If the IRS ever audits you or your business and finds insufficient records or significant mistakes in your record keeping, it can disallow significant deductions. The IRS can also impose hefty fines and penalties, possibly forcing you out of business and wiping out your life savings as well.

Record keeping should be part of your everyday business routine. I hate paperwork as much as anyone. But I also hate shaving every morning, keeping fat out of my diet, and carrying out the garbage in the rain, and these tasks never seem to go away. However, I’ve discovered some record-keeping shortcuts I’ll share with you.

Random Business Record Inspections

You may be audited after written notice, but there are no IRS inspectors roaming around spot-checking your records. In many states, however, employment or sales tax auditors can show up unannounced and demand to see records. So, just like the Boy Scouts, be prepared. If you don't have it all together, tell the auditor (politely) to go away and make an appointment.

Should You Hire a Bookkeeper?

When it comes to keeping records, you can either do it yourself, or hire someone.

Maybe you can't afford a full- or part-time bookkeeper when you're starting out, but keep it in mind if and when your business succeeds. Some folks actually like doing other people's paperwork, leaving you with more time to focus your talents on your enterprise.

Typically, outside bookkeepers charge \$15 to \$50 per hour or may charge a flat monthly fee. They can take care of a small business for as little as \$50 to \$100 a month. Because this is a tax deductible expense, Uncle Sam is paying part of the bookkeeper's salary.

**CAUTION**

Don't just hire anyone claiming to be a bookkeeper. Check references. Also, learn enough about your own records so that you can tell whether the bookkeeper knows her stuff. Tax pros can recommend a bookkeeper, or they may have folks on staff to do the job (accountants themselves are not bookkeepers). The American Institute of Professional Bookkeepers is also a possible source of information if you're looking to hire someone (www.aipb.org).

Keep in mind that the IRS holds owners responsible for any bookkeeper screw-ups. The

following is a sad but true story of an entrepreneur we'll call Barney, who didn't pay attention to what his bookkeeper was up to, and paid the price.

EXAMPLE: Barney owned T-Wrecks, an auto body shop. He had no patience for bookkeeping, so he hired Lorraine to do it for him. She came in once a week to do T-Wrecks's books, pay the bills, and file various tax reports. Lorraine was a faithful worker, and so Barney was upset when she suddenly quit after two years and moved to parts unknown. Shortly thereafter, an IRS collector came calling about unfiled and unpaid payroll taxes. Barney discovered that sweet Lorraine had embezzled \$38,000, including unpaid federal taxes. Barney had to go into his savings to pay for the unpaid taxes—plus hefty penalties—or face the padlocking of his body shop by the IRS.

If the size of your operation justifies it, insure your business against a bookkeeper's dishonesty. Check with your insurance agent.

Manual or Computer System?

You can keep business records manually—the pencil and paper way—or with a computer. The IRS doesn't care as long as your system accurately reflects your business's transactions. If you just throw papers in a shoebox and forget them, you're an audit waiting to happen.

A microbusiness, such as a home-based consultant, independent contractor, or freelancer, might get by with a check register, adding-machine tapes, and an accordion file for paid bills.

Every time you incur an expense (or once a week or month), you'll note in your records the following:

- a brief description of the business purpose of the transaction (office rent, new stapler, gas, and so on)
- the amount

- the date, and
- whom you paid (Chevron, Kinko's, and so on).

Whether you use a computer or pencil, the basics of bookkeeping are the same. You must keep accounts showing your enterprise's financial activities. Accounts refer to the categories where transactions are noted in your records—such as advertising, rent, and utilities.

Paid business receipts should be organized by category—rent, entertainment, travel, equipment, and so on—and not by week or month. This allows you to total up the different types of expenses at the end of the year for tax preparation—and you'll be ready if the IRS comes calling.



SEE AN EXPERT

Run it by a tax pro. Have a tax pro review your system early on to make sure it is okay. This can avoid headaches when it comes time for filing tax returns or when the auditor calls. And the tax pro's fees are tax deductible business expenses.

Manual Bookkeeping System

Pen and paper work fine for very small enterprises and cost only \$5 to \$20 for ledger paper or a

simple business record booklet, both of which can be found at an office supply store.

An adequate record-keeping system for a small business (without employees) typically includes:

- checkbook register—preferably from a separate bank account for your business
- summary of receipts of gross income—totaled daily, weekly, or monthly
- monthly summary listing of expenses
- disbursements record (check register or expense journal) showing payments of bills, and
- asset purchase listing (equipment, vehicles, real estate used in business, and so on).

Keep income and expense records using ledger sheets listing your income and expense items. A sample ledger sheet is shown below.

The chart below is called an expense journal. Gross receipts are recorded on an income journal, which is similar.

As the Jumbalaya Enterprises example below illustrates, the first three columns of an expense journal list how your business paid for a certain transaction—with cash, credit charge, or check. Next is the date an expense was paid or incurred.

Next describe the expense item under “transaction.” (Ideally, every expense item should be taken directly from an invoice, receipt, cash

(Sample Ledger Sheet)
Jumbalaya Enterprises—Expense Journal—April 20xx

Check No.	Cash	Credit Card	Date	Transaction	Advertising	Utilities	Supplies	Rent
		VISA	4/1	Daily News	48.00			
122			4/15	Prop. Mgmt. Serv.				782.75
	✓		4/21	Office World			62.44	
123			4/30	City Electric		91.50		
124			4/30	KFOO Radio	95.00			
April 20xx				TOTALS	143.00	91.50	62.44	782.75

voucher, check register, or other document showing it was incurred by the business.)

Going across the top of the right side of the paper are headings for listing the category of each type of expense, such as rent, supplies, or utilities. If an item doesn't fit anywhere, add a column for miscellaneous.

After each item of current expense or income is entered, all of the columns are periodically totaled. Typically, totals are run weekly or monthly. Finally, the 12 months are added up at the end of the year.

Prepare sheets at least monthly. It's better to do it daily or weekly, when everything is fresh in your mind.



TIP

Retain old records. Worksheets (and your receipts for expenses) should be stored at least three years after you file your tax return. This is the period in which the IRS or state tax agency is most likely to audit. Better yet—save them for six years if space permits. And keep in mind that if you ever sell your business, a buyer may want to see old records to verify its financial history.

A Shortcut for Expense Records

File paid bills, canceled checks, and other business documents where you can easily find them. Some people use manila folders or an accordion file divided into car, utilities, entertainment, and so on.

At a minimum, stuff receipts in the proper folders throughout the year and total them up at tax time. Staple the adding machine tape to each folder or stack of receipts. If this works, good for you.

Computerized Bookkeeping System

Record keeping on a computer works on the same principles as the manual system, but the computer automates the process. A simple software program like *Quicken* (Intuit) eliminates the need for a handwritten set of books. With *Quicken*, you can print out most tax-related records such as an expense journal in a flash.

These inexpensive (and tax deductible) programs are fine for most small businesses. I use *Quicken Deluxe* in my tax law practice. For businesses with inventories, a more sophisticated software program like *QuickBooks* or *Sage Peachtree Accounting* works better.

Checkbook register format. *Quicken* works like a checkbook register, as shown below. Each transaction, usually a business expense or an item of income, is typed in or can be downloaded automatically from your bank or credit card accounts. Typically, it's either a check out of, or deposit into, your bank account or a business charge on a credit card. (You should also record cash transactions in *Quicken* as shown in the illustration below.)

Assign a number or category name to each transaction and type it in. For instance, you could make "201" for office rent, or just type "rent," which tells the computer to group together all rent payments. Category 202 could be "supplies," and so on. You could track "advertising" as category 301, or break it into subcategories such as 302 for "ads—yellow pages," 303 for "ads—newspaper." The software "learns" on the fly. After you select a category, it will automatically match that up with the same payee in the future.



TIP

When you pick expense category names, use the same names the IRS uses on its forms. This will make things much easier at tax time. See Schedule C in Chapter 7 for ideas for names, such as "rent," "office expense," "utilities," and so on.

Sample Quicken Check Register (Along With Credit Card and Petty Cash Registers)

Date	Num	Payee	Memo	Category	Payment	Clr	Deposit	Balance
10/24/2011		Opening Balance		[Checking]		R	5,860.33	5,860.33
11/1/2011	122	Prop Mgt Services		Rent	1,850.17			4,010.16
11/9/2011	DEP			Sales			2,000.00	6,010.16
11/14/2011	123	Daily News		Ads	95.00			5,915.16
11/15/2011	124	Office World		Printing and Reproduction	104.13			5,811.03
11/25/2011		City Electric		Utilities:Gas & Electric	191.50			5,619.53

Net Worth: \$5,860

Current Balance: 5,860.33 Ending Balance: 5,619.53

Quicken groups the entries like a manual system ledger sheet and does the math. You are now only a keystroke away from up-to-date profit and loss reports at any time of the year. Bonus—you can use the programs to track your personal finances as well.

Take it from someone who did not grow up in the computer age—*Quicken* is easy to use, even if you type like a snail. An hour should get you up and running, no kidding. No more math errors that always plagued me when I kept books by hand.

Avoiding computation mistakes isn't the best reason to use *Quicken*—the categorization feature is my favorite. It eliminates the chore of going through (or paying someone to organize) a jumble of paper. A computerized system allows you to see your income and expenses—by category—instantly.

Plus, your profit and loss statement is a click away and you can whip out a financial statement for a bank or creditor instantly.

You'll also have at least 90% of the data needed to prepare your business's annual tax schedule or return. If you do your own tax preparing, this feature is a godsend. *Quicken* is compatible with tax preparation programs like *H&R Block At Home* or *TurboTax*. You can move your financial data from *Quicken* into your tax software without having to reenter the same figures. *TurboTax* or *H&R Block At Home* (in one of their several versions) will prepare any type of business tax return: sole proprietor, C or S corporation, partnership, or limited liability company. *Balance Your Books* offers online bookkeeping services at www.balanceyourbooks.com.

Sample Quicken Income Statement

Jumbalaya Enterprises	
Income Statement	
1/1/2011 Through 1/31/2011	
Category	1/1/2011–1/31/2011
Inc/Exp	
Income	
Gross Sales	<u>2,000.00</u>
Total Income	2,000.00
Expenses	
Ads	143.00
Rent Paid	782.75
Supplies	62.44
Utilities	<u>91.50</u>
Total Expenses	<u>1,079.69</u>
Total Inc/Exp	<u>920.31</u>

EXAMPLE: Jack Johnson is a medical technology consultant with only one client, who pays him monthly. Keeping track of gross receipts is no problem. Expenses are more troublesome. Jack has a home office and occasionally hires help. He travels worldwide, drives his car for business, pays insurance, and so on. He writes business checks or uses credit cards. Over the course of a year, Jack incurs hundreds of different expenses, so he needs a good record-keeping system. Jack keeps a business checking account plus a personal account. Jack is an ideal candidate for *Quicken*.

Businesses with inventories. *Quicken* doesn't cover issues for sellers of goods that maintain an inventory. A slightly more expensive program, *QuickBooks* (Intuit), handles inventory, billing,

payroll management, customer records, and more complex small business bookkeeping tasks. There are other programs as well in the \$100 to \$200 range, and some are available online for a monthly charge.

What Kinds of Records to Keep

There are three principal types of business records: income, expenses, and capital expenditures. Let's look at each of these categories. If your business has employees, you'll also need payroll records. Those are covered in Chapter 6.

Income Records

Your operation may take in money from one or many sources. For goods or services sold, these inflows are called gross receipts.

Business records should list money received and the source of each item—for instance, “retail sales.” Identifying money received is necessary because deposits into your business's bank account are not always gross receipts or income which is taxed.

There are many valid explanations for why a deposit may not be taxable income. For instance, you might transfer \$10,000 from your personal bank account into your business bank account to buy inventory. Or maybe you took out a bank loan or sold your Harley or received an inheritance from Aunt Bea, and put that money into your business account.



TIP

Write it down. Write down the source of the deposit on the deposit slip or in your checkbook while it is fresh in your mind (e.g., “sales,” “loan,” or whatever). I make photocopies of all my bank deposit items and write notes to explain any that aren't taxable income. Always keep in mind that an IRS audit may be in your future.

There are numerous ways to track business income, such as cash registers with built-in memories and credit card billers. IRS auditors favor paper bank deposit records, so keep copies of deposit slips identifying the sources of funds deposited and monthly bank statements.

What about record keeping for cash income? Some businesses, like take-out restaurants, arcades, convenience stores, vending machine operators, bars, and laundries are “cash intensive.” The IRS keeps a close eye on them. Most small time operators handle cash at least occasionally. So, make sure you track and report cash in case an auditor comes calling. And, if you take in more than \$10,000 in cash, traveler’s checks, money orders, or bank drafts from one individual or business, you must file IRS Form 8300 for each transaction. (See Chapter 20 for details.)



CAUTION

Keep notes on income sources. Jot down the origin of all money deposited in both your business and personal bank accounts. If the IRS audits you, the first things they want to see are bank statements, deposit slips, and cash records for all business and personal accounts. If your total bank deposits are greater than your reported income, you will have some explaining to do. Otherwise, the auditor will assume the difference was unreported income—and hit you with more tax, interest, and penalties.

Income reported on Form 1099. If you receive Form 1099s showing payments for your services, make sure this 1099 income is on your tax return. The IRS computer routinely matches up Form 1099s to income reported on tax returns. If a Form 1099 is wrong, ask the issuer to send a corrected form to you and the IRS.

EXAMPLE: Dr. No was snagged by the IRS on a computer check of Form 1099 payments. He had claimed less gross income (\$240,000) than Medicare alone had reported to the IRS that it paid him (\$295,000)—not even taking

into account his non-Medicare patients! (How Dr. No thought he could get away with this is beyond me.) He was audited and the IRS added heavy penalties and interest to his audit bill. Dr. No also could have been charged criminally with tax evasion.

Expense Records

As the old saying goes, to make money you have to spend money. The good news is that ordinary and necessary business expenditures are deductible against your gross receipts. (See Chapter 2.)



TIP

Get organized. Keep a business diary and calendar, like a day planner, or use a program like Microsoft *Outlook* on your computer or smartphone. You need to keep a record of expenses for at least three years. An organizer lists appointments and helps you note tax-related things like travel, names of business contacts entertained, and out-of-pocket cash expenses for bridge tolls and parking. For expense items that are not obviously business-related (travel, entertainment), make notes to explain the business purpose. (See “Business Entertainment, Meals, and Travel Records,” below.)

You’ll need to keep track of all your expenses, but this is only part of the job. To be audit-proof, keep documents showing the bills were paid—such as register receipts, invoices, credit card statements, cancelled checks, and rent receipts. Microbusinesses can get by with saving receipts and invoices in accordion folders or envelopes by expense category (supplies, travel, and so on). Larger businesses need more paperwork organization.

Even though canceled checks and paid receipts are the standard way to back up your business expenses, IRS auditors usually accept financial institution statements showing electronic transfers that document your payments. As long as the statement shows the checks cleared, credit card

Sample Travel and Entertainment Log

Date	Type of Expense	Place	Business Purpose	Amount				
				Travel	M & E*	Other	Mileage	Reimbursed
8/23/2011	Meal	Ritz	Discuss New Advertising with Bill Jones	—	\$60	—	12 miles	—
Totals 8/2011				—	\$60	—	12 miles	—

* Meals and Entertainment

transactions, or electronic funds transfers, you don't need the actual canceled checks or charge slips. The statement should have the date, name of the payee, and the amount of the charge or payment. For unusual or larger amounts, it's a good idea to keep the charge slips and canceled checks, just in case.

Business Entertainment, Meals, and Travel Records

The law requires more stringent record keeping for travel, meals, and entertainment expenses (IRC § 274). In tax lingo, these are called T&E items.

For each T&E expense you must document five elements:

- date
- amount
- place
- business purpose, and
- business relationship.

Get in the habit of making notes of these five items on the back of receipts and in your business diary or calendar. For example, write on your calendar or appointment book, "May 11, Lunch with Bill Jones, client, to discuss new advertising campaign. Ritz Restaurant, \$60 with tip." If you used your American Express card, write "Bill Jones" and the topic discussed ("television advertising on Channel 5") on the back of the charge slip.

Cash Expenses Are Deductible But ...

...they may be hard to prove to an auditor without some documentation. The IRS understands that even in a credit card world, cash is still around. Small things like tips, cab rides, parking expenses, and postage are usually okay. Expect questions from the IRS however, if you pay for a new car with cash.



TIP

No receipts are necessary for expense items less than \$75. The IRS no longer requires you to keep any paid receipts, canceled checks, bills, or other proof of single-expense items of less than \$75 each. Even though you don't have to keep receipts for these payments, you still must keep a record of the expense, showing the date, amount, and business purpose. There is one exception: For lodging expenses, you must have a receipt regardless of the amount.

Asset Records

Whenever a business purchase offers a benefit that will last for longer than one year—like a fax machine, a building, a car, office furniture, or the like—the IRS classifies it as a business asset

or capital item. These assets must be tracked separately from current business expense records. (Accountants call asset records the fixed asset schedule or asset log.)

You don't have to know the terminology—just keep a separate file for each kind of asset. Show the date of purchase and the type of asset: computer, truck, machinery, and so on. And, unless it is obvious, write a short explanation of how the asset is used in the business.

Long-term assets are not immediately deductible like everyday operating expenses, such as rent or telephone bills. Generally, you must take depreciation or amortization deductions for assets over several years, unless you can use Section 179.

Life is much simpler for leased assets. With the limited exception of vehicles, you simply deduct lease payments as current expenses instead of maintaining an asset log for them.

How to keep asset records

For business assets, keep records showing:

- **A description of each item, the date acquired, and how you acquired it (usually by purchasing it).** Typically, this data appears on an invoice or receipt from the seller. The description is important because the tax code has different rules for different assets. For instance, office furniture is deductible over seven years, and computers over five. (These categories are discussed in Chapter 3.)
- **The date you started using the asset in your business—the month and year it was placed in service.** Ordinarily you start using something as soon as you acquire it, but not always, so note it.
- **Your tax basis in the asset.** Your beginning basis is how much you paid for an asset, including sales tax, installation, and delivery. Your basis can increase if you later make improvements or modifications—such as adding more memory to a computer.

Conversely, the basis decreases whenever you claim depreciation deductions on your tax return.

- **The sales price of the asset when you dispose of it.** If the asset became worthless or obsolete, include the date you discarded it.
- **Any costs of selling the asset.** For instance, you may have had to take out a newspaper ad to sell your old computer.

Keep track of assets and their tax bases by hand, using ledger sheets or asset log books, or with a computer program such as *QuickBooks*.

Special records for mixed-use property

Congress calls certain assets, such as laptop computers, mixed-use property—items with a high potential for personal as well as business use. The tax code term for this property is listed property.

If you use listed property strictly for business there's no need to keep usage records. But if any listed property provides you with a personal benefit, or if you keep it at home, you must separate and track your business and personal use. Of course, you can't claim any tax deduction for the personal use time.

Listed property. Listed items include assets such as:

- autos, airplanes, and other forms of motorized transportation
- entertainment-type property such as cameras and camcorders, and
- computers and related peripheral equipment (if not used exclusively at a regular business location).

Satisfy the special record-keeping requirement by keeping a logbook showing dates, times, and business purpose. Or write notes in a calendar or business diary. (For more information on listed property, see IRS Publication 946, *How to Depreciate Property*.)

EXAMPLE: Joan buys a laptop computer. She uses it 60% of the time for her direct marketing business. Her son, Jason, uses it the rest of the time for school projects and video games. Joan should keep a log by the computer, showing the times it was used for her business and for personal purposes, in case the IRS comes calling.

Section 179 rule. You may immediately deduct the cost of listed property under Section 179 only if it is used more than 50% for business. (See Chapter 3 for a full explanation of Section 179.)

EXAMPLE: Joan pays \$3,000 for her computer that she uses 60% for business. She can write off \$1,800 ($\$3,000 \times 60\%$) as a Section 179 expense. But if Joan only used it 45% of the time for business, she could not claim any of its cost as a Section 179 write-off. Instead, she would have to take depreciation deductions over six years.

How Long Records Should Be Kept

The normal federal statute of limitations gives the IRS only three years to audit you and your business, starting from the later of the due date or the date you file a tax return. (Note that if you never file a return for a given tax year, all bets are off—you can be audited forever.) So, three years is the absolute minimum period for record retention. However, for serious tax misdeeds, the IRS can go back six years—and for outright fraud, it can go back forever.

State tax agencies can inspect your records, too. Some state statutes of limitations for auditing are longer than the IRS's. My advice is to keep your regular tax-related documents—receipts, invoices, bank statements—for six years after filing your tax return.

Asset records on equipment, vehicles, and real estate should be kept for six years after the asset has been disposed of.

EXAMPLE: In 1999, Calista bought a building for her insurance agency. She deducted all expenses of maintaining the building and took annual depreciation deductions. Calista sold her agency, including the real estate, in 2010. She filed her tax return reporting the sale of the business on April 15, 2011. Calista should keep her 1999 documents on the purchase of the building until six years after the date of the sale—2017.

Bookkeeping Methods of Tracking Income and Expenses

There are two manual methods for keeping your books, called single-entry and double-entry bookkeeping.

If you are doing books by hand and don't have a lot of transactions, the single-entry method is okay. A more accurate way is the double-entry method. Let's briefly look at both ways, and then move quickly into the computer age.

Single-Entry System

Single-entry bookkeeping is the easiest way to go. Like it sounds, you write down each transaction once, indicating the type of expense or income. You can use ledger paper or just a lined notebook. Easy, huh? The Jumbalaya Expense Journal shown above is an example of single-entry bookkeeping.

A single-entry system, however, does not work for tracking inventory, loans, assets, and liabilities. For this, you need a double-entry system.

Double-Entry System

In a double-entry system, each transaction requires an entry first as a debit and the second

time as an equal credit. For instance, if you buy a cell phone for \$500, it will be recorded as a debit on one side of your records because you spent money. It will be recorded as a credit on the other side because you've acquired an asset. You have a perfect balance.

A double-entry system is more time-consuming if done by hand because everything is written in two places. This requires the old-fashioned set of books: journals and ledgers. As illustrated below, all transactions are first entered into a journal, then are totaled and posted (written) on a ledger sheet—the same amount is written on a line in the journal and then again in the ledger by category.

Here is a very simple example of a double-entry system, showing a payment of rent by Sam's Computer Shop.

General Journal of Sam's Computer Sales & Service

Date	Description of Entry	Debit	Credit
10/5/2012	Rent Expense	\$1,000	
	Cash		\$1,000

As you can see, payment of rent resulted in two separate journal entries—a debit to rent expense of \$1,000, and an equal credit to cash of \$1,000. The debits in a double-entry method (here, \$1,000) must always equal the credits (\$1,000). If they don't, you know there is an error somewhere. So, double-entry allows you to balance your books, which you can't do with the single-entry method.



TIP

Computers make it easy. With an accounting software program, the double-entry is done automatically. You enter the new data only once, and the computer makes the second entry. Programs such as *Quicken* and *QuickBooks* (Intuit) and *Peachtree* (Sage) create a set of double-entry books on your computer. The programs eliminate the extra step or the need to comprehend debits and credits—and don't make math errors. And, if you prepare your own tax returns,

you can export data from these programs directly into *TurboTax* or *H&R Block At Home*.

Timing Methods of Accounting: Cash and Accrual

There are two accounting methods for recording income and expenses, called the cash and accrual methods. These are two sets of rules for the timing of income and expenses, meaning when they are incurred.

A venture's income and expenses must ordinarily be reported in the period in which they occur. (Normally the period is a calendar year, but for a few businesses it may be a fiscal year that doesn't end on December 31.)

EXAMPLE: Monique buys \$7,000 in supplies for her hairdressing salon in January 2011. Monique hasn't filed her 2010 income taxes yet—can she deduct the \$7,000 expense on her 2010 tax return? No, because the expense was incurred in 2011.

Less clear-cut is the question: What if Monique had bought the supplies in 2010, but didn't pay for them until 2011? In which year does Monique take the deduction? To answer, you need to know the difference between cash and accrual methods of accounting and which one Monique's business uses.

Cash Method Accounting

Cash method refers to recording an item of income when you receive it or an expense when you pay it. Don't take the word cash here literally; it covers any kind of payment—checks, barter, credit cards—as well as the green stuff.

The cash method makes sense even to us non-accountants. You simply report income in the tax year you receive it and an expense in the tax year you pay it.

**CAUTION**

The cash method seems simple, but there are a few special tax rules to watch out for. The doctrine of constructive receipt requires counting some items as income before you physically receive them. This means you have income, for tax purposes, as soon as it is available or credited to your account—even if you don't take it.

EXAMPLE: Ray gets a \$3,000 check for services in early December 2011, but doesn't deposit it until January 2012. Because Ray could have cashed it in 2011—the banks were open and the check was good—2011 is the tax year in which Ray constructively received the \$3,000.

Conversely, there is no deduction in the current year for items paid for but not yet received.

EXAMPLE: Ray got a special deal on Consulting Times, a monthly business publication. He paid \$360 for a three-year subscription in July of 2011. He can deduct only \$60 in 2011 ($\frac{1}{6}$ of the total); the balance must be prorated over the term of the subscription. Ray can deduct \$120 ($\frac{1}{3}$) in 2012, \$120 ($\frac{1}{3}$) in 2013, and \$60 ($\frac{1}{6}$) in 2014.

Most service providers like doctors, consultants, and other professionals use the cash method of accounting.

**TIP**

Prepay and deduct some expenses. The IRS allows some flexibility in prepaying and deducting expenses at the end of the year. For instance, if you pay January's office rent on December 27, you'll get the deduction a year earlier. As long as you don't prepay an expense more than 30 days in advance, you're okay.

Accrual Method Accounting

Businesses with inventories of goods and manufacturers generally must use either the accrual method or a hybrid method of accounting.

Most other small businesses can use the cash method instead if they are either:

- unincorporated with inventories but have annual gross receipts of less than \$1 million, or
- corporations with annual gross receipts of less than \$5 million.

The accrual method is contrary to most small business folks' way of thinking. With accrual accounting, income is treated (and taxed) as received when it is earned—regardless of when it is actually received. On the other side, an expense is recorded (and deductible) at the time the obligation arises—which is not necessarily when it is paid.

In accountant's lingo, business expenses and income accrue the moment they become "fixed." To be fixed, income and expenses must meet the "all events" test. This means that everything required to earn the income, or to cause an expense to be owed, must have happened. At that point in time the income or expense accrues, whether or not any cash has changed hands.

EXAMPLE: George's Foundry, which uses the accrual method, receives a \$4,500 deposit in 2011 for custom ironwork to be manufactured in 2012. George won't report \$4,500 as income in 2011 because it hasn't been earned yet. On the expense side, if the foundry incurs a \$250 charge in 2011 for lawyer's fees relating to the contract, it is accrued and tax deducted in 2011—even if not paid for until 2012.

**SEE AN EXPERT**

Get help setting up accrual accounting. If you select or must use the accrual method, bring in an accountant. One reason is that there are two inventory accounting methods (LIFO, "last in, first out," and FIFO, "first in, first out") to choose from. Discuss this with a CPA or enrolled agent who is familiar with your industry, whether it is a gas station, a loan company, or a boutique.

Hybrid and Special Accounting Methods

It often makes sense to use a combination of the cash and accrual methods. For instance, Waldo's electronics store may sell and repair items. Waldo may use the cash method for repairs, but Waldo's inventory may be accounted for on an accrual basis. Both methods may be used simultaneously, creating a hybrid accounting system.

If Waldo's business grosses more than \$5 million, he needs permission from the IRS to adopt a hybrid or special method of tax accounting. (See a tax pro or IRS Publication 538, *Accounting Periods and Methods*.) But if his gross receipts are less than \$5 million, he doesn't need permission to adopt a hybrid or special method of tax accounting. (IRS Notice 2001-76.)

Other special accounting methods, beyond the scope of this book, apply to farmers and certain businesses working on long-term contracts, manufacturers, and building contractors.

Changing Accounting Methods

A business must choose an accounting method and tell the IRS which method it is using on its tax return (a box on the form must be checked).

The business then must use the same accounting method forever unless the IRS gives written permission to switch to another method.

The IRS is concerned that whenever an accounting method is changed the business could obtain an unfair tax advantage—or some expenses or income could get “lost” in the transition.

To get IRS permission for changing methods, file Form 3115, *Application for Change in Accounting Method*. File it within 180 days before the end of the year for which you want to make the change. There is a \$500 application fee, but the IRS may waive the fee if you ask. (See Rev. Proc. 97-27 or a tax pro for further details.)

Exception: If there is a fundamental change in the operation of your business—say, from selling goods to offering only services—then IRS permission is not required.

EXAMPLE: Kate's Lamp Repair Service, which had been using the cash method, starts stocking and selling lamps. Kate now has an inventory, so she wants to use an accrual accounting method for her retail sales. She doesn't need to get permission from the IRS because there was a fundamental change in operation.

Accounting Periods: Calendar Year or Fiscal Year

All enterprises must keep their books based on annual accounting periods, called tax years. For individuals in business, it's usually the calendar year—starting on January 1 and ending on December 31.

Some enterprises may choose an alternative tax-reporting period called a fiscal year. This is any one-year period that does not end on December 31.

A business notifies the IRS of its accounting period by checking the designated box on its annual tax return form. Once chosen, the accounting period usually cannot be changed without written approval from the IRS.

Regardless of which accounting tax year is used, a business's payroll taxes must be reported on a calendar year basis.

Calendar Year Period

Sole proprietors, partnerships, limited liability companies, S corporations, and personal service corporations must report as calendar-year entities—unless they can convince the IRS they qualify to use a fiscal year.

Fiscal Year Period

Small enterprises rarely choose a fiscal year instead of a calendar tax year. A fiscal year is a one-year period ending on the last day of any month except December.

Sole proprietors, partnerships, limited liability companies, S corporations, and personal service corporations can use a fiscal year only by showing the IRS a business reason for it, such as a cyclical or seasonal business—for instance, farming. For IRS permission, file Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year*. Consult an accountant first to see if a fiscal year really makes sense.

Individual taxpayers are never allowed to report on a fiscal year basis.

Short Tax Years

A short tax year occurs when a new business starts on any day but January 1. For instance, if Sandra's Sunshades opens on July 15 and uses a calendar tax year reporting period, her first tax year is only five and a half months and ends on December 31. Likewise, a short year occurs if Sandra closes her doors at any time other than December 31.

A short tax year is significant because it requires Sandra to prorate certain tax deductions, such as depreciation of assets, to match the short period in that first or last year of operation. (See Chapter 3.)

Bookkeeping and Accounting in a Nutshell

- The IRS doesn't prescribe any particular format for keeping business records as long as your records clearly reflect your income and expenses.
- You can choose either a handwritten or computerized accounting system.
- There are two principal accounting methods for recording income and expenses—the cash and accrual methods. Most small businesses use the simpler cash method.
- A software program like *Quicken*, *QuickBooks*, or *Peachtree* is the best way for a small business to keep track of its accounts.
- Small businesses are almost always required by the IRS to keep records and report taxes on a calendar year basis.
- Poor accounting is the number one reason small businesses lose IRS audits.
- Business records should be kept at least three years after you file a tax return, but six years is even better (and safer).

Resources

- IRS Publication 552, *Recordkeeping for Individuals*. This publication is helpful especially if you are new in business or keeping your own books. It discusses kinds of records to keep and how long to keep them.
- IRS Publication 583, *Starting a Business and Keeping Records*; Publication 551, *Basis of Assets*; Publication 946, *How to Depreciate Property*; Publication 538, *Accounting Periods and Methods*; and Publication 535, *Business Expenses*. These booklets can get fairly technical, but if you are hungry for tax knowledge or bent on preparing your own tax return, this is stuff you must know.
- *Keeping the Books*, by Linda Pinson (Dearborn Trade Publishing). A primer for those of you keeping your books without a computer.
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs Publishing). A wealth of practical record-keeping and accounting tips from a longtime CPA.
- *Accounting and Recordkeeping Made Easy for the Self-Employed*, by Jack Fox (John Wiley & Sons). This book offers case studies, worksheets, and sample forms to help you work through basic accounting in a small business.
- Basic accounting system information is available free through the Small Business Administration (SBA). Send for the *Resource Directory for Small Business Management* from SBA, Mail Code 7111, 409 Third Street, SW, Washington, DC 20416, or go to the SBA's website at www.sba.gov.

Business Losses and Failures

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“There is no such thing as justice—in or out of court.”

—Clarence Darrow

The term “risky business” comes to mind whenever I see another brave soul take the plunge into a new venture. Most operations lose money during their start-up phase. Some folks hang in there until the business turns the corner, while most others throw in the towel after a year or two. A majority will go under because they run out of cash, and a few do so badly that they will be forced to file for bankruptcy. Only 15 in 100 new ventures survive the first five years.

Fortunately, the tax code softens the blow for people who lose money in business. Congress evidently believes that one way to encourage new enterprises is to give a tax break to those who try. After all, when the business flourishes, the government shares in profits (through taxation), so why shouldn’t it absorb part of the losses as well? The amount of tax relief from Uncle Sam, however, depends on things like whether your business is incorporated, and whether you are active in the business or just an investor.

Taking tax benefits from business losses is the subject of this chapter. By losses, we are not talking about bad debts that you incur when you don’t get paid. That’s covered in Chapter 2.

Unincorporated Business Losses

Struggling sole proprietors, partners, and limited liability company members can reap a tax benefit from business losses. The tax code dictates how much and when these entities can claim business operating losses. The rules for corporations are different and are discussed below in “Incorporated Business Losses.”

Owners’ Operating Losses and Carryovers

Owners of a sole proprietorship, a partnership, an S corporation, or a limited liability company can claim their business operating losses on their annual Form 1040 individual tax returns.

Accountants call this a net operating loss, or NOL. It simply means a business’s deductions are more than its income.

An NOL is used to offset other income, which usually results in a tax savings. However, an NOL can’t reduce a person’s taxable income to below zero. Instead, the law allows unused NOLs to be taken in other tax years, which could produce a tax refund. This is called an NOL carryover.

EXAMPLE: John Jones Hardware, a sole proprietorship, shuts its doors in 2011. The business had profits in its first two years, 2009 and 2010, but lost \$100,000 in its third and final year of operation. In 2011, John’s wife, Jean, worked at the phone company to keep the family afloat and earned \$25,000. The Joneses can claim \$25,000 of the total \$100,000 hardware store net operating loss on their tax return in 2011. The balance of \$75,000 can be carried over to offset income in other (past or future) tax years.

The following is a summary of the NOL rules. Special provisions for farming aren’t covered here. These rules are complicated so you may want to consult with a tax pro if you have an NOL.

- An NOL is first taken to offset your other income in the year it occurred.
- If the loss exceeds your other income for the year, you can amend tax returns from the past two years to get a tax refund, assuming you paid tax or had income in those years. This is called an NOL carry-back.

- If there's unused loss, you can carry the loss forward for 20 years. The overall effect is to get the tax benefit of business losses in future years. This is called an NOL carry-forward.

EXAMPLE: Harry started Nebula Graphic Designs in 2011, and his expenses exceeded his gross receipts by \$40,000 that year. On the side, Harry worked as a printer's representative, netting \$12,000 in commissions. Harry can claim \$12,000 of the business operating loss to wipe out his commission income for that year. Then Harry can carry the balance of the net operating loss of \$28,000 back up to two years by amending his past tax returns. If he still has any unused loss, Harry can keep claiming the loss against income until it is fully used up or until the 20-year period expires in 2031.

Note. For losses in 2008 and 2009 only, you can carry back the loss for up to five years. However, an NOL carried back to the fifth year cannot be used to offset more than 50% of that year's income.



TIP

How to carry over business operating

losses. Tell the IRS on your Form 1040 tax return that you intend to carry over your net operating loss. Attach IRS Form 3621, *Net Operating Loss Carry-Over*. This form also shows how much loss is left over after the first tax year. See a tax pro or IRS Publication 536 for more information on NOLs.

Investors and Losses

If you put money into someone else's business as a loan or investment, you don't get a tax deduction for any of that venture's operating losses. You have to be an active participant to get a tax benefit. However, all is not lost, so to speak. If the business goes belly up, you may be able to claim

a capital loss on your personal tax return. Capital losses can be used to offset any capital gains you have. For example, if you sell Google stock.

Any excess capital loss (after offsetting your capital gain) can then be deducted against ordinary income (money earned from a business or wages). You can only deduct up to \$3,000 in any year (or \$1,500 if married but filing separately).

Any capital loss over \$3,000 can be carried forward in future years (at \$3,000 per year), until it's used up or you die. (You cannot carry a capital investment loss back to prior years.)

EXAMPLE 1: Jake and Mona Willow invest \$45,000 in Jake Jr.'s digital imaging business. The business fails, and the Willows lose their entire investment—a \$45,000 capital loss. If the Willows have other income but no capital gains to offset this loss, it will take them 14 more years (at \$3,000 per year) to deduct the whole \$45,000.

EXAMPLE 2: As in the above example, the Willows lose their entire \$45,000 investment in 2009. They deduct \$3,000 as a tax loss against their ordinary income in 2010. Then, in 2011, the Willows sell Google stock, realizing an \$8,000 capital gain. In 2011, they can claim \$11,000 of the investment loss from Jake Jr.'s digital imaging business (the \$8,000 capital gain plus \$3,000 of ordinary income from their jobs). After taking \$3,000 as a tax loss in 2010 and \$11,000 in 2011, the Willows have \$31,000 in capital losses to claim in 2012 and beyond. They can deduct only \$3,000 per year, unless they have some more capital gains in the future, like their sale of Google stock.



TIP

There is a way to get beyond the \$3,000 annual loss limitation—if the business is incorporated. See "Incorporated Business Losses," below.

Additional Tax Rules for Losses

In addition to the normal tax rules for deducting operating business losses (NOLs), there are three more hurdles to clear to get a tax break. However, with the possible exception of the hobby loss rules, none of these laws affect most small-time operators.

- **Hobby loss rules.** You cannot deduct an NOL from a venture unless it was operated with a profit motive—in other words, if it was a true business that you were trying to make income from, rather than just a hobby. (See Chapter 14 for a full explanation of how this rule works.) This tax law is aimed mainly at folks who race cars or yachts, or breed show horses and then claim tax loss benefits—but the IRS uses it to go after common folk as well.
- **At-risk rules.** You may deduct no more than your basis (economic investment) in the venture. This law targets so-called tax shelter investments. However, losses in excess of your basis can be carried forward indefinitely to future years' tax returns to the limit of your basis in each year.

EXAMPLE: In exchange for a one-third partnership interest, Manny puts \$5,000 cash into ABC Partners along with a \$10,000 promissory note—a promise to put more money into the partnership in the future. Manny doesn't ever pony up the additional \$10,000 and the business goes belly up. Manny's tax loss is limited to \$5,000, not \$15,000, under the at-risk rules.

- **Passive activity loss rules.** Do you have ownership in, but do not materially participate in, a business venture? Welcome to the complicated passive activity loss rules. In essence, nonworking investors may not deduct an operating loss from the business

in excess of the income produced. The next example shows how this rule works.

EXAMPLE: ABC partnership takes in \$30,000, but spends \$40,000 (the business loses \$10,000). Manny, a nonworking one-third partner, doesn't get to claim a loss of \$3,333 on his tax return. (There are different passive activity rules for closely held C corporations and for rental real estate investments. Both of these topics are beyond the scope of this book.)

Incorporated Business Losses

Can tax benefits from a small business corporation's losses be taken by the shareholders individually or only by the corporation? The answer depends on several factors, discussed below.

Shareholder Losses

One tax code provision to know by number is Section 1244. This allows shareholder-investors in small business corporations—whether active in the business or not—to more quickly deduct their investment loss if the business fails or when they sell their stock.

Section 1244 allows individual shareholders to take losses beyond the \$3,000 annual deduction limit that normally applies to individual investors.

Section 1244 allows a tax loss of up to \$100,000 (for a married couple filing jointly or a single taxpayer), or \$50,000 for a married person filing separately. The loss is claimed on the shareholders' 1040 tax return, reducing or eliminating their tax bill or producing a refund.

Also, any excess loss (over \$100,000) can be carried forward and claimed in future years. However, for future years, the regular \$3,000 per year limit applies. Over \$3,000, the loss can be used only to offset any capital gains from

investments, not ordinary income from earnings. Here's an example showing this isn't as complicated as it sounds.

EXAMPLE: Gordon and Joella Hall buy \$150,000 in stock in LowTech, a Section 1244 corporation. LowTech does poorly (customers apparently wanted high-tech), and the Halls sell their stock for \$20,000, losing \$130,000 of their investment. The Halls have earned income of \$100,000 that year, so they can offset \$100,000 of their \$130,000 loss on their tax return.

The remaining \$30,000 of the Halls' loss is called a capital loss carryforward; it can be claimed on the Halls' future years' capital gains. If the Halls don't have any capital gains to absorb the loss carryforward, they can still claim a deduction of \$3,000 per year. In this case, it takes the Halls ten years to use up the excess capital loss of \$30,000.



CAUTION

Make sure your corporation qualifies for

Section 1244 treatment. Section 1244 only applies if, when the corporation was formed, the total money or property it received in return for stock was less than \$1 million. Your corporation must pass a resolution stating its intent to be a Section 1244 corporation when it is made. The details are in "The Importance of Issuing Section 1244 Stock" in Chapter 8.

How to claim a Section 1244 loss

If you take a loss under Section 1244, you must file a statement with your individual tax return explaining the loss. If the IRS audits you and finds that Section 1244 wasn't applicable, your loss is treated under the capital loss rules discussed in "Investors and Losses," above. Under these rules, you can't offset your loss against ordinary income

beyond the \$3,000 capital loss annual limit. (See the example above.) If you are unclear how to do this, ask a tax pro for help.

Related party rule

Sales of Section 1244 stock between related parties are suspect to the IRS. So, if you claim a tax loss from a transaction with someone related to you by blood or marriage, an IRS auditor may disallow it. Related parties are parents, children, and in-laws, as well as other businesses controlled by you or family members.

To be safe, sell stock to nonrelatives. For instance, if the corporation stock you own is worthless, sell it to a friend for a dollar. Your buddy has nothing to lose by helping you out—except the dollar.

C Corporation Operating Losses

C corporation shareholders cannot claim operating losses on their individual tax returns. The losses are locked in the C corporation because it is a separate tax entity from its shareholders. This is different from an S corporation.

Instead, corporations themselves can claim a tax loss. For instance, if corporate income taxes are paid in one year, they can be refunded in a future year that the corporation loses money. This is called a corporate net operating loss (NOL).

Alternatively, a corporate NOL can be carried back to get refunds of corporate income taxes paid in the past.



TIP

Get your corporate tax refund fast. File

IRS Form 1139, *Corporation Application for Tentative Refund*. The IRS must act within 90 days and issue a refund. If your corporation hasn't yet filed its prior year's tax return, use Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback*, instead.

Business Losses in a Nutshell

- Most business losses produce tax benefits—although there are many rules about taking loss deductions.
- Operating loss deduction rules are less stringent for business owners than for investors.
- The manner in which tax benefits are claimed from a loss depends on the form of the business entity—sole proprietor, corporation, LLC, or partnership.
- In all business entities except C corporations, losses pass through to the individual owners who are active in the operation.
- C corporation losses belong to the corporation and not to the shareholders.
- Shareholders in C corporations can deduct losses on their investment only in the year the business fails or when they sell their stock.
- Small C corporation businesses should issue stock qualified under Section 1244 when formed to give shareholders the maximum tax deduction for losses.
- Losses can't be claimed for hobbies.

Resources

All of the following IRS publications shed light on the topic of reaping tax benefits from business losses.

- IRS Publication 550, *Investment Income and Expenses*.
- IRS Publication 925, *Passive Activity and At-Risk Rules*.
- IRS Publication 536, *Net Operating Losses*.
- IRS Publication 541, *Partnerships*.
- IRS Publication 908, *Bankruptcy Tax Guide*.

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“If there isn’t a law, there will be.”

—Harold Farber

Chances are, if your venture is successful, you won’t be able to do it alone. Hiring workers carries a whole new set of tax responsibilities. With employees, the IRS (and your state) will be looking to see if you are filing payroll tax returns and making bank deposits of your employees’ taxes.

Every employer must:

- withhold payroll taxes from employees’ wages
- deposit the withheld employee income taxes, together with the business’s share of Social Security and Medicare taxes, to the accounts of the IRS and the state, and
- file various reports with the IRS, Social Security Administration, and the state.

According to the IRS, the majority of small businesses fall behind in filing reports or making federal tax deposits. While many delinquencies are oversights—like missing a deadline—others reflect poor financial management or ignorance of employer tax obligations.

It is tempting, in a cash crunch, to pay rent, utilities, and key suppliers instead of making a payroll tax deposit. Employers sometimes rationalize that since it takes the IRS months (if not years) to find out, employment taxes can wait. Not true.



CAUTION

Pay your payroll taxes, in full and on time.

If you don’t, the IRS will knock at the door, and it won’t be a tap. The IRS tacks on interest and large penalties to delinquent payroll taxes. The bill can skyrocket so fast that businesses often fail as a result. And unlike ordinary debts, payroll taxes survive the death of the business or bankruptcy of the enterprise. Payroll taxes are also personal liabilities of the business owner(s).

Using independent contractors instead of employees avoids payroll taxes, withholding, and form filing. Contractors make quarterly estimated tax payments to the IRS and pay their own Social Security and Medicare taxes. (See Chapter 7.) However, the IRS or your state may audit you to see if anyone you call an independent contractor rather than an employee is classified correctly. If not, the consequences can be very expensive, as we shall see in “Misclassifying Employees as Independent Contractors,” below.

Employer Identification Numbers

All employers—solos to corporations and everything in between—must get a federal Employer Identification Number (EIN). Use this nine-digit number on all business-related forms you send to the IRS.

To get an EIN by mail, send IRS Form SS-4, *Application for Employer Identification Number*, to the IRS address in the instructions to the form. This form is on the IRS’s website at www.irs.gov, or at all IRS and Social Security offices. There is no charge to get an EIN.

If you apply for your EIN by mail, it usually takes several weeks to process. If any tax filings are due before you get your number back, write “applied for” in the space for the EIN.

You can also get your EIN by telephone or online. Call the IRS at 866-816-2065 and request an EIN (make sure you fill out the form first; you’ll have to read the answers over the phone). You will then mail the filled-out SS-4 form to the IRS. Or, file for it online at www.irs.gov.

If you have more than one business, you need a different EIN for each one. If you change the form of your entity, like from a sole proprietorship to a corporation, or from a partnership to a limited liability company, you must get a new EIN.

Sample Form SS-4

Part
1

The Basics

Form SS-4 (Rev. January 2010) Department of the Treasury Internal Revenue Service		Application for Employer Identification Number (For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.) ▶ See separate instructions for each line. ▶ Keep a copy for your records.		OMB No. 1545-0003 EIN	
Type or print clearly.	1	Legal name of entity (or individual) for whom the EIN is being requested <u>Oliver Q. Cromwell</u>			
	2	Trade name of business (if different from name on line 1) <u>AQC Plumbing</u>		3	Executor, administrator, trustee, "care of" name
	4a	Mailing address (room, apt., suite no. and street, or P.O. box) <u>Post Office Box 666</u>		5a	Street address (if different) (Do not enter a P.O. box.) <u>123 Drain Lane</u>
	4b	City, state, and ZIP code (if foreign, see instructions) <u>Farout, CA 95555</u>		5b	City, state, and ZIP code (if foreign, see instructions) <u>Farout, CA 95555</u>
	6	County and state where principal business is located <u>Flushing, California</u>			
	7a	Name of responsible party <u>Oliver Q. Cromwell</u>		7b	SSN, ITIN, or EIN <u>666-66-6666</u>
	8a	Is this application for a limited liability company (LLC) (or a foreign equivalent)? ☐ Yes ☒ No		8b	If 8a is "Yes," enter the number of LLC members <u> </u> ▶
	8c	If 8a is "Yes," was the LLC organized in the United States? ☐ Yes ☐ No			
	9a	Type of entity (check only one box). Caution. If 8a is "Yes," see the instructions for the correct box to check.			
	☒ Sole proprietor (SSN) <u>666-66-6666</u> ☐ Estate (SSN of decedent) <u> </u> ☐ Partnership ☐ Plan administrator (TIN) <u> </u> ☐ Corporation (enter form number to be filed) ▶ <u> </u> ☐ Trust (TIN of grantor) <u> </u> ☐ Personal service corporation ☐ National Guard ☐ State/local government ☐ Church or church-controlled organization ☐ Farmers' cooperative ☐ Federal government/military ☐ Other nonprofit organization (specify) ▶ <u> </u> ☐ REMIC ☐ Indian tribal governments/enterprises ☐ Other (specify) ▶ <u> </u> ☐ Group Exemption Number (GEN) if any ▶ <u> </u>				
9b	If a corporation, name the state or foreign country (if applicable) where incorporated		State	Foreign country	
10	Reason for applying (check only one box)				
☐ Started new business (specify type) ▶ <u> </u> ☐ Banking purpose (specify purpose) ▶ <u> </u> ☐ Purchased going business ☐ Changed type of organization (specify new type) ▶ <u> </u> ☒ Hired employees (Check the box and see line 13.) ☐ Created a trust (specify type) ▶ <u> </u> ☐ Compliance with IRS withholding regulations ☐ Created a pension plan (specify type) ▶ <u> </u> ☐ Other (specify) ▶ <u> </u>					
11	Date business started or acquired (month, day, year). See instructions. <u>08/10/2010</u>		12	Closing month of accounting year <u>December</u>	
13	Highest number of employees expected in the next 12 months (enter -0- if none). If no employees expected, skip line 14.				
Agricultural Household Other 2					
15	First date wages or annuities were paid (month, day, year). Note. If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) <u>5/1/2011</u>				
16	Check one box that best describes the principal activity of your business.				
☒ Construction ☐ Rental & leasing ☐ Transportation & warehousing ☐ Health care & social assistance ☐ Wholesale-agent/broker ☐ Real estate ☐ Manufacturing ☐ Finance & insurance ☐ Accommodation & food service ☐ Wholesale-other ☐ Retail ☐ Other (specify) <u> </u>					
17	Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided. <u>Plumbing contracting services</u>				
18	Has the applicant entity shown on line 1 ever applied for and received an EIN? ☐ Yes ☒ No If "Yes," write previous EIN here ▶ <u> </u>				
Third Party Designee	Complete this section only if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.				
	Designee's name			Designee's telephone number (include area code) ()	
	Address and ZIP code			Designee's fax number (include area code) ()	
Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.					
Name and title (type or print clearly) ▶ <u>Oliver Q. Cromwell</u>					Applicant's telephone number (include area code) (333) 333-3333
Signature ▶ _____ Date ▶ _____					Applicant's fax number (include area code) (333) 333-4444
For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form SS-4 (Rev. 1-2010)					

What Are Payroll Taxes?

The term payroll taxes covers three different taxes that every employer is responsible for:

- **Income tax.** Owners must withhold federal income tax from each employee's paycheck.

By January 31, owners must send an IRS W-2 form to each employee showing the total payments and tax withholdings from their wages in the previous year.

By February 28, employers must file IRS Form W-3 (summary and transmittal form) and send copies of all the W-2s to the Social Security Administration, which shares this data with the IRS.

IRS Publications 15 and 15A, Circular E, *Employers' Tax Guide*, show you how to figure tax withholding for employees, and Form W-4, *Employee's Withholding Allowance Certificate*, shows how much to withhold from employees' paychecks for federal income tax purposes. But one look at Circular E (64 pages of fine print) might convince you to hire a payroll tax service or a tax pro to do the calculations and prepare the forms.

- **Social Security and Medicare tax (FICA).** The FICA tax rate consists of a Social Security tax, which has been 6.2% for many years, and a Medicare tax of 1.45%. The combined 7.65% tax rate must be paid by the employer and the employee for a total FICA tax of 15.3%. Employers are required to withhold the employee's 7.65% share of FICA taxes from each paycheck and also must match this amount. The 15.3% tax is payable on the first \$106,800 of earnings; all income over this amount is taxed and withheld at 2.9% for Medicare (one-half each of the employer and employee's 1.45% share).

For 2011, the FICA tax rate for employees was lowered by 2% to 5.65%; the employer tax rate remained unchanged. So, the total FICA rate for 2011 is 13.3%.

- **Federal unemployment tax (FUTA).** This tax goes to the unemployment insurance system and is paid by the employer. The employee pays no part of FUTA. The maximum FUTA is \$56 per employee per year. A credit toward FUTA is allowed for any state unemployment taxes paid, but the employer must have paid the state unemployment tax on time. (A sample Form 940 is below.)
- **Employee's Withholding Allowance Certificate (Form W-4).** Make sure every employee fills out a W-4 form for your records (you don't file it with the IRS). Use this form to calculate the correct amount of tax withholding for each employee (see sample form below).

States Have Payroll Taxes, Too

Most states that tax income also require employers to withhold employees' state income taxes, similar to the federal law. Some cities, such as New York City, have payroll taxes, too. Also, all states impose unemployment taxes on employers, which can be significant. Check with your state's unemployment tax agency for your state's rate and for the rules and reporting forms.



TIP

Verify Social Security numbers. Workers do not always give their correct Social Security numbers when filling out a Form W-4. Employers should call the Social Security Administration (SSA) to verify the worker's correct number. You can contact the SSA at 800-772-1213. This is also a way to make sure you don't violate the law against hiring illegal immigrants.

Sample Form W-4

Part
1

The Basics

Form W-4 (20XX)

Purpose. Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay. Consider completing a new Form W-4 each year and when your personal or financial situation changes.

Exemption from withholding. If you are exempt, complete **only** lines 1, 2, 3, 4, and 7 and sign the form to validate it. Your exemption for 2011 expires February 16, 2012. See Pub. 505, Tax Withholding and Estimated Tax.

Note. If another person can claim you as a dependent on his or her tax return, you cannot claim exemption from withholding if your income exceeds \$950 and includes more than \$300 of unearned income (for example, interest and dividends).

Basic instructions. If you are not exempt, complete the **Personal Allowances Worksheet** below. The worksheets on page 2 further adjust your withholding allowances based on itemized deductions, certain credits, adjustments to income, or two-earners/multiple jobs situations.

Complete all worksheets that apply. However, you may claim fewer (or zero) allowances. For regular wages, withholding must be based on allowances you claimed and may not be a flat amount or percentage of wages.

Head of household. Generally, you may claim head of household filing status on your tax return only if you are unmarried and pay more than 50% of the costs of keeping up a home for yourself and your dependent(s) or other qualifying individuals. See Pub. 501, Exemptions, Standard Deduction, and Filing Information, for information.

Tax credits. You can take projected tax credits into account in figuring your allowable number of withholding allowances. Credits for child or dependent care expenses and the child tax credit may be claimed using the **Personal Allowances Worksheet** below. See Pub. 919, How Do I Adjust My Tax Withholding, for information on converting your other credits into withholding allowances.

Nonwage income. If you have a large amount of nonwage income, such as interest or dividends, consider making estimated tax payments using

Form 1040-ES, Estimated Tax for Individuals. Otherwise, you may owe additional tax. If you have pension or annuity income, see Pub. 919 to find out if you should adjust your withholding on Form W-4 or W-4P.

Two earners or multiple jobs. If you have a working spouse or more than one job, figure the total number of allowances you are entitled to claim on all jobs using worksheets from only one Form W-4. Your withholding usually will be most accurate when all allowances are claimed on the Form W-4 for the highest paying job and zero allowances are claimed on the others. See Pub. 919 for details.

Nonresident alien. If you are a nonresident alien, see Notice 1392, Supplemental Form W-4 Instructions for Nonresident Aliens, before completing this form.

Check your withholding. After your Form W-4 takes effect, use Pub. 919 to see how the amount you are having withheld compares to your projected total tax for 2011. See Pub. 919, especially if your earnings exceed \$130,000 (Single) or \$180,000 (Married).

Personal Allowances Worksheet (Keep for your records.)

A Enter "1" for yourself if no one else can claim you as a dependent B Enter "1" if: • You are single and have only one job; or • You are married, have only one job, and your spouse does not work; or • Your wages from a second job or your spouse's wages (or the total of both) are \$1,500 or less. C Enter "1" for your spouse. But, you may choose to enter "-0-" if you are married and have either a working spouse or more than one job. (Entering "-0-" may help you avoid having too little tax withheld.) D Enter number of dependents (other than your spouse or yourself) you will claim on your tax return E Enter "1" if you will file as head of household on your tax return (see conditions under Head of household above) F Enter "1" if you have at least \$1,900 of child or dependent care expenses for which you plan to claim a credit G Child Tax Credit (including additional child tax credit). See Pub. 972, Child Tax Credit, for more information. • If your total income will be less than \$61,000 (\$90,000 if married), enter "2" for each eligible child; then less "1" if you have three or more eligible children. • If your total income will be between \$61,000 and \$84,000 (\$90,000 and \$119,000 if married), enter "1" for each eligible child plus "1" additional if you have six or more eligible children H Add lines A through G and enter total here. (Note. This may be different from the number of exemptions you claim on your tax return.) ▶ H For accuracy, complete all worksheets that apply. • If you plan to itemize or claim adjustments to income and want to reduce your withholding, see the Deductions and Adjustments Worksheet on page 2. • If you have more than one job or are married and you and your spouse both work and the combined earnings from all jobs exceed \$40,000 (\$10,000 if married), see the Two-Earners/Multiple Jobs Worksheet on page 2 to avoid having too little tax withheld. • If neither of the above situations applies, stop here and enter the number from line H on line 5 of Form W-4 below.	A 1 B 1 C 1 D 0 E 1 F 0 G 0 H 4
---	---

Cut here and give Form W-4 to your employer. Keep the top part for your records.

Form W-4 Department of the Treasury Internal Revenue Service	Employee's Withholding Allowance Certificate ▶ Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.	OMB No. 1545-0074 20XX
1 Type or print your first name and middle initial. Arturo Z.	Last name Toscanini	2 Your social security number 777 77 7777
Home address (number and street or rural route) 654 Via Veneto		3 ☐ Single ☒ Married ☐ Married, but withhold at higher Single rate. Note. If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.
City or town, state, and ZIP code Rome, Georgia 44444		4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a replacement card. ▶ ☐
5 Total number of allowances you are claiming (from line H above or from the applicable worksheet on page 2)		5 4
6 Additional amount, if any, you want withheld from each paycheck		6 \$ 0
7 I claim exemption from withholding for 2011, and I certify that I meet both of the following conditions for exemption. • Last year I had a right to a refund of all federal income tax withheld because I had no tax liability and • This year I expect a refund of all federal income tax withheld because I expect to have no tax liability. If you meet both conditions, write "Exempt" here ▶ 7		
Under penalties of perjury, I declare that I have examined this certificate and to the best of my knowledge and belief, it is true, correct, and complete.		
Employee's signature (This form is not valid unless you sign it.) ▶ Arturo Z. Toscanini		Date ▶ 2/2/20xx
8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.) Boston Philharmonic, 888 Bean St., Boston MA 99999		9 Office code (optional) 987 10 Employer identification number (EIN) 654321

For Privacy Act and Paperwork Reduction Act Notice, see page 2.

Cat. No. 10220Q

Form **W-4** (2011)

Reporting and Depositing Payroll Taxes

Small businesses must deposit each employee's withheld income taxes and FICA contributions (Social Security and Medicare) monthly.

- Employers make these deposits at IRS-approved banks using coupons with each deposit. The bank forwards the payments to the U.S. Treasury.
- Alternatively, you can make deposits electronically from your bank account. You can sign up for the *Electronic Federal Tax Payment System* (EFTPS) online at www.eftps.gov, or call the IRS at 800-555-4477 to enroll. The EFTPS program also accepts credit card payments, but there is a hefty surcharge.

There are some exceptions to the monthly deposit requirement:

- If the total payroll taxes are \$2,500 or less for the month, deposits may be made quarterly instead of monthly.
- If the payroll taxes are \$1,000 or less for the entire year, the deposit is due only once a year.
- If the total annual payroll taxes are over \$200,000, they must be made electronically.

Payroll Tax Forms

Unless you hire someone to handle payroll tax for you, you'll have to become familiar with the following tax forms. All these forms may be filed by mail or electronically through the EFTPS process described above.

Form 8109-B, Federal Tax Deposit Coupon.

Obtain coupons from the IRS by calling 800-829-1040. Must be submitted with each payroll

tax deposit to ensure proper credit to a business's payroll tax account. Alternatively you may do this by computer if you are enrolled in the EFTPS program (see above).

Form 941, Employer's Quarterly Federal Return.

Obtain from the IRS, or by calling 800-829-1040, or at the IRS website (www.irs.gov). Also, if you're using *QuickBooks* (Intuit) or similar accounting software, it will generate and fill in Form 941 for you. Form 941 must be filed four times a year. It reports your federal payroll tax deposits for a three-month period. It also shows how many employees your business had in that period. (Sample form follows.) If you discover an error in your Form 941, file Form 941-X to correct it.

Form 944, Employer's Annual Federal Tax Return.

A very small business will use this form instead of Form 941 because it's for an employer who owes withheld federal income taxes and FICA of \$1,000 or less. Filed and paid only once a year instead of every quarter. Correct any errors in Form 944 by filing Form 944-X.

Form 940 (or Form 940-EZ), Employer's Annual Federal Unemployment Tax Return (FUTA). Obtain this from the IRS by calling 800-829-1040 or at www.irs.gov. This is a once-a-year form to report and pay the employer's unemployment tax to the IRS and claim credit for payments made to any state unemployment agency. (A sample form is shown below.)



TIP

Consider using a payroll tax service. IRS fines for late filing of these forms can be severe. If you're too busy or can't be bothered with filling in and filing forms on time, then check out the cost of a payroll tax service. Paychex and Intuit Payroll Services are two good ones. Private tax pros can also take care of this task for you, and it's a deductible business expense.

Sample Form 941—page 1

Form 941 for 20XX: Employer's QUARTERLY Federal Tax Return (Rev. February 2010) Department of the Treasury — Internal Revenue Service		950110 OMB No. 1545-0029
(EIN) 0 0 - 1 2 3 4 5 6 7		
Employer identification number 00-1234567		
Name (not your trade name) Rock E. Roder		
Trade name (if any) Congo Cone Creamery		
Address 777 Milky Way		
Number Vanilla Bean	Street VA	Suite or room number 23001
City Vanilla Bean	State VA	ZIP code 23001

Report for this Quarter of 2010
 (Check one.)
☒ 1: January, February, March
☐ 2: April, May, June
☐ 3: July, August, September
☐ 4: October, November, December

Read the separate instructions before you complete Form 941. Type or print within the boxes.

Part 1: Answer these questions for this quarter.

1 Number of employees who received wages, tips, or other compensation for the pay period including: <i>Mar. 12</i> (Quarter 1), <i>June 12</i> (Quarter 2), <i>Sept. 12</i> (Quarter 3), <i>Dec. 12</i> (Quarter 4)	1	two
2 Wages, tips, and other compensation	2	19,500.00
3 Income tax withheld from wages, tips, and other compensation	3	3,220.00
4 If no wages, tips, and other compensation are subject to social security or Medicare tax		☐ Check and go to line 6.
5 Taxable social security and Medicare wages and tips:		
Column 1	Column 2	
5a Taxable social security wages 19,500.00 × .124 =	2,418.00	
5b Taxable social security tips . × .124 =	.	
5c Taxable Medicare wages & tips 19,500.00 × .029 =	565.50	
5d Total social security and Medicare taxes (Column 2, lines 5a + 5b + 5c = line 5d)	5d	2,983.50
6 Total taxes before adjustments (lines 3 + 5d = line 6)	6	6,203.50
7 CURRENT QUARTER'S ADJUSTMENTS, for example, a fractions of cents adjustment. See the instructions.		
7a Current quarter's fractions of cents .		
7b Current quarter's sick pay .		
7c Current quarter's adjustments for tips and group-term life insurance .		
7d TOTAL ADJUSTMENTS. Combine all amounts on lines 7a through 7c	7d	6,203.50
8 Total taxes after adjustments. Combine lines 6 and 7d	8	.
9 Advance earned income credit (EIC) payments made to employees	9	6,203.50
10 Total taxes after adjustment for advance EIC (line 8 – line 9 = line 10)	10	.
11 Total deposits for this quarter, including overpayment applied from a prior quarter and overpayment applied from Form 941-X or Form 944-X 6,203.50		
12a COBRA premium assistance payments (see instructions)		.
12b Number of individuals provided COBRA premium assistance reported on line 12a .		
13 Add lines 11 and 12a	13	.
14 Balance due. If line 10 is more than line 13, write the difference here. For information on how to pay, see the instructions	14	.
15 Overpayment. If line 13 is more than line 10, write the difference here .		

☐ Apply to next return.
☐ Check one ☐ Send a refund.

▶ You MUST complete both pages of Form 941 and SIGN it. Next ▶

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 17001Z Form 941 (Rev. 2-2010)

Sample Form 941—page 2

950210

Name (not your trade name)

Employer identification number (EIN)

Part 2: Tell us about your deposit schedule and tax liability for this quarter.

If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see *Pub. 15 (Circular E)*, section 11.

16 ☒ v ☐ a Write the state abbreviation for the state where you made your deposits OR write "MU" if you made your deposits in *multiple* states.

17 Check one: ☐ Line 10 on this return is less than \$2,500 or line 10 on the return for the preceding quarter was less than \$2,500, and you did not incur a \$100,000 next-day deposit obligation during the current quarter. Go to Part 3.

☐ You were a monthly schedule depositor for the entire quarter. Enter your tax liability for each month. Then go to Part 3.

Tax liability: Month 1

Month 2

Month 3

Total liability for quarter Total must equal line 10.

☐ You were a semiweekly schedule depositor for any part of this quarter. Complete *Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors*, and attach it to Form 941.

Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.

18 If your business has closed or you stopped paying wages ☐ Check here, and enter the final date you paid wages .

19 If you are a seasonal employer and you do not have to file a return for every quarter of the year . . . ☐ Check here.

Part 4: May we speak with your third-party designee?

Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.

☐ Yes. Designee's name and phone number

Select a 5-digit Personal Identification Number (PIN) to use when talking to the IRS.

☐ No.

Part 5: Sign here. You MUST complete both pages of Form 941 and SIGN it.

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign your name here

Rock E. Roder

Print your name here

Rock E. Roder

Print your title here

Date

Best daytime phone

Paid preparer's use only

Check if you are self-employed . . . ☐

Preparer's name

Preparer's SSN/PTIN

Preparer's signature

Date

Firm's name (or yours if self-employed)

EIN

Address

Phone

City State

ZIP code

Sample Form 940—page 1

Form **940 for 20XX: Employer's Annual Federal Unemployment (FUTA) Tax Return** 850110
 Department of the Treasury — Internal Revenue Service OMB No. 1545-0028

(EIN) Employer identification number 1 2 - 3 4 5 6 7 8 9

Name (not your trade name) Paris Marriott

Trade name (if any) Airhead Enterprises

Address 77 Sunset Strip
 Number Street Suite or room number
 Hollyweird CA 66666
 City State ZIP code

Type of Return
 (Check all that apply.)

☐ a. Amended
☐ b. Successor employer
☐ c. No payments to employees in 2010
☐ d. Final: Business closed or stopped paying wages

Read the separate instructions before you fill out this form. Please type or print within the boxes.

Part 1: Tell us about your return. If any line does NOT apply, leave it blank.

1 If you were required to pay your state unemployment tax in ...

1a One state only, write the state abbreviation 1a C A
 - OR -
 1b More than one state (You are a multi-state employer) 1b ☐ Check here. Fill out Schedule A.

2 If you paid wages in a state that is subject to CREDIT REDUCTION 2 ☐ Check here. Fill out Schedule A (Form 940), Part 2.

Part 2: Determine your FUTA tax before adjustments for 2010. If any line does NOT apply, leave it blank.

3 Total payments to all employees 3 78,000.00

4 Payments exempt from FUTA tax 4 0

Check all that apply: 4a ☐ Fringe benefits 4c ☐ Retirement/Pension 4e ☐ Other
 4b ☐ Group-term life insurance 4d ☐ Dependent care

5 Total of payments made to each employee in excess of \$7,000 5 57,000.00

6 Subtotal (line 4 + line 5 = line 6) 6 57,000.00

7 Total taxable FUTA wages (line 3 - line 6 = line 7) 7 21,000.00

8 FUTA tax before adjustments (line 7 × .008 = line 8) 8 168.00

Part 3: Determine your adjustments. If any line does NOT apply, leave it blank.

9 If ALL of the taxable FUTA wages you paid were excluded from state unemployment tax, multiply line 7 by .054 (line 7 × .054 = line 9). Then go to line 12 9

10 If SOME of the taxable FUTA wages you paid were excluded from state unemployment tax, OR you paid ANY state unemployment tax late (after the due date for filing Form 940), fill out the worksheet in the instructions. Enter the amount from line 7 of the worksheet 10

11 If credit reduction applies, enter the amount from line 3 of Schedule A (Form 940) 11

Part 4: Determine your FUTA tax and balance due or overpayment for 2010. If any line does NOT apply, leave it blank.

12 Total FUTA tax after adjustments (lines 8 + 9 + 10 + 11 = line 12) 12 168.00

13 FUTA tax deposited for the year, including any overpayment applied from a prior year 13 149.00

14 Balance due (If line 12 is more than line 13, enter the difference on line 14.)
 • If line 14 is more than \$500, you must deposit your tax.
 • If line 14 is \$500 or less, you may pay with this return. For more information on how to pay, see the separate instructions 14 19.00

15 Overpayment (If line 13 is more than line 12, enter the difference on line 15 and check a box below.) 15

Check one: ☐ Apply to next return.
☐ Send a refund.

► You MUST fill out both pages of this form and SIGN it.

Next ►

For Privacy Act and Paperwork Reduction Act Notice, see the back of Form 940-V, Payment Voucher. Cat. No. 112340 Form 940 (2010)

Sample Form 940—page 2

850210	
Name (not your trade name)	Employer identification number (EIN)
Part 5: Report your FUTA tax liability by quarter only if line 12 is more than \$500. If not, go to Part 6.	
16 Report the amount of your FUTA tax liability for each quarter; do NOT enter the amount you deposited. If you had no liability for a quarter, leave the line blank.	
16a 1st quarter (January 1 – March 31) 16a	149.60
16b 2nd quarter (April 1 – June 30) 16b	18.40
16c 3rd quarter (July 1 – September 30) 16c	0.00
16d 4th quarter (October 1 – December 31) 16d	0.00
17 Total tax liability for the year (lines 16a + 16b + 16c + 16d = line 17) 17	168.00 Total must equal line 12.
Part 6: May we speak with your third-party designee?	
Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.	
☒ Yes. Designee's name and phone number Fash N. Slave 	
Select a 5-digit Personal Identification Number (PIN) to use when talking to IRS 7 7 7 7 7	
☐ No.	
Part 7: Sign here. You MUST fill out both pages of this form and SIGN it.	
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments made to employees. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.	
X Sign your name here	Print your name here Paris Marriott Print your title here Owner Date 01 / 25 / 20xx Best daytime phone 999-999-3333
Paid preparer use only	
Check if you are self-employed . . . ☐	
Preparer's name	
Preparer's signature	
Firm's name (or yours if self-employed)	
Address	
City	
State	
ZIP code	

Personal Responsibility for Payroll Taxes

Uncle Sam takes payroll taxes very seriously, and so should you. In effect, you—the employer—act as an agent of the government, and hold these taxes “in trust” until they are handed over to the Treasury. Violation of this trust can bring on fines (the Trust Fund Recovery Penalty or “TFRP”) and in extreme cases, even jail time!

The IRS can, and often does, padlock the doors of a business and seize its assets for payroll tax law violations. What’s more, the IRS (and most states as well) can hold business owners and, in some cases, employees personally responsible for unpaid payroll taxes. We’ll look at this issue more closely to show just how serious this matter is.

One of the reasons for forming a business entity, like a limited liability company or corporation, is to avoid personal liability for business debts. Well, that shield doesn’t work when it comes to payroll taxes and the Trust Fund Recovery Penalty that can be imposed for failure to pay those taxes. (IRC § 6672.)

The IRS can hold someone who owns or works in a business that owes payroll taxes personally liable for the TFRP. The IRS must find that (1) the individual(s) had the responsibility for making the missed payroll deposits, and (2) they acted willfully in not seeing that the payment was made.



CAUTION

Owners are almost always found

responsible. Business owners can’t delegate away payroll tax responsibility under the TFRP to employees or outsiders, like tax pros. The IRS has ten years to collect the TFRP and can seize just about any asset of the responsible person. (See Chapter 19.)

What if a business’s employee or outsider neglects or forgets to pay, or worse, steals the payroll taxes? The owner is still on the hook, says the IRS. The rationale is that the owner chose, and

has the duty of supervising, that person. Only on rare occasions have owners been forgiven when the wrongdoer acted without the owner’s knowledge.

Any individual found responsible for payroll taxes is liable for all of the unpaid trust fund portion. This means the amount of income taxes for the employees that should have been withheld and deposited plus one-half of the FICA taxes (Social Security and Medicare). Why the government lets anyone off the hook for the other half of the FICA tax and the FUTA tax is a mystery to me. But, it’s a small break, as the responsible person will still owe over 90% of the payroll taxes.

When it comes to pinning on the personal responsibility tag, the IRS does not always stop with the head people. Nonowner employees, such as a bookkeeper or office manager, can also be held responsible. Even outside accountants and attorneys for the business can be tagged.

Because the IRS is eager to find as many people responsible as possible, its agents are given wide latitude in assigning personal responsibility. The IRS may question anyone to find out who is to blame for the missed payments and filings.

The IRS looks at a number of factors:

- Who made the business’s financial decisions?
- Who signed, or had authority to sign, checks? (This is the factor the IRS seems most impressed with.)
- Who had power to direct payment (or nonpayment) of bills?
- Who had the duty of tax reporting?
- Was the nonpayment willful?

Willfulness is mainly what the IRS is searching for. You were willful if you knew payroll taxes were owed and didn’t do anything about it—even if you never intended to cheat the IRS.



TIP

Protect yourself from co-owners’

misdeeds. If you share financial responsibilities with others—that is, you’re a partner, LLC member, or corporation shareholder—get a written agreement

with the other owners that contains a payroll tax indemnification clause. This obligates your co-owners to reimburse any payroll tax penalty assessed against you personally, plus any costs of fighting the IRS.

A suitable clause looks like this:

“All co-owners (or shareholders) agree to indemnify any of the others that may be held liable for any unpaid payroll tax liabilities of the business that are proposed or assessed against them personally, together with legal costs in contesting the taxes, except amounts in proportion to their ownership (shares) in the business.”

Even with this indemnification clause, you are still liable to the IRS for the whole thing if the others don't pay. This clause simply requires them to pay you back some of what the IRS takes out of your hide. It helps as long as the other owners are still solvent (or become so).

If you are found personally liable for unpaid federal payroll taxes, you may appeal. (Maybe you don't believe you are liable, or you just want to delay the collection process.) IRS appeals officers can reverse a TFRP finding. And if you lose the IRS appeal, you may take the IRS to court. (See Chapter 21.)

Payroll taxes cannot be legally discharged in bankruptcy. You will either have to pay, or live with a payroll tax debt hanging over your head for ten years (when the statute of limitations for collection runs out).

One way to reduce a payroll tax debt is through a negotiation process called an “offer in compromise.” The IRS will sometimes make a deal if it is convinced that you don't have the assets or adequate income to pay in full. (See Chapter 19.)

If You Get Behind on Payroll Tax Payments

If your enterprise gets behind in payroll taxes, you need to catch up as fast as possible.

Pay current taxes first. If you can't pay all past and present payroll taxes, first make payments

for the current tax quarter—if you still have employees. Then start paying the delinquent payroll taxes. Paying current quarterly taxes on time stops interest and heavy penalties from accumulating. Perhaps more important, the IRS is much more likely to give you time to pay past delinquencies if you've made your current quarter's payroll tax deposits.

Designate late payments. Whenever paying past due employment taxes, tell the IRS specifically how you want back payments credited—the type of tax and tax periods. This is called designating tax payments. Designating ensures payments don't get misapplied to a different tax period or account. Also, if the payments don't cover the whole tax bill—which is frequently the case—state that you want the trust fund portion of payroll taxes credited first.

Here's how to designate your payments:

Step 1. Write a letter, like the one below, to the IRS office where you file your employment tax returns. If you're in doubt as to where to send it, call the IRS at 800-829-1040 to speak to a taxpayer service representative.

Sample Letter to the IRS

XYZ CORPORATION

September 15, 2011

Dear IRS:

Please apply the enclosed payment of \$1,529 to the account of XYZ Corporation, EIN 94-5555555, for payroll tax Form 941 liability, 3rd Quarter of 2011. Apply to trust fund portion only.

Yours truly,

Sandra Shoestein

Sandra Shoestein, President

Encl. Check

Step 2. Enclose your check. Write in the lower left-hand corner: “Apply to trust fund portion only.” Under this, write your employer identification number, the tax type, and the period the payment is for, such as: “EIN 94-555555, for payroll tax Form 941 liability, 3rd quarter 2011.”

Step 3. Send the letter and check to the IRS by certified mail.



TIP

Inspect your IRS payroll tax records. To find out if the IRS has given you proper credit for all your payroll tax payments, order a printout of your account. Call the IRS at 800-829-1040 and ask for your “BMF,” or business master file. Tell them the specific tax periods you want, such as “3rd and 4th quarters of 2011.” You should receive this information by mail within two weeks. Compare the IRS records with yours. If the printout is too full of strange codes, call the IRS to ask for an explanation, or show it to a tax pro.

Classifying Workers: Employee or Independent Contractor?

Individuals performing services for your business are usually classified by the IRS as either regular employees or independent contractors (meaning self-employed for tax purposes).

A small percentage of people are in one of two other categories: statutory employees or statutory nonemployees. We talk about these classifications below.

All of these distinctions are very important to the IRS, and it can be costly if you don’t pay attention to them.

Reporting Payments to Independent Contractors

With a true independent contractor, business owners don’t have to withhold or report payroll

taxes. However, an independent contractor may choose to have tax withholding by a payor. There’s a box on the 1099 form that notes withholding.

IRS Form 1099-MISC. Business owners must issue IRS Form 1099-MISC annually to service providers, including independent contractors, that the business has made payments to in the previous year. Naturally the IRS gets copies too—to make sure these payments were reported as income by the recipients.

Each 1099 form shows the name, address, and tax ID number of each recipient along with the total amount paid. There are 11 versions of Form 1099, but the 1099-MISC is the one you are most likely to use. Below is a summary listing of who must get a 1099, and who is excepted from the rule.

Who Should Get a Form 1099-MISC?

- Independent contractors
- Professionals. Attorneys, accountants, and consultants
- Landlords (if you paid \$600 or more for rent)
- Anyone who is not an employee who received \$600 or more in prizes or awards
- Anyone who receives royalty payments above the \$10 threshold from your business
- Anyone who buys consumer products from your business to resell anywhere other than a permanent resale establishment

Exception: 1099 filing not required. Don’t report independent contractor payments to the IRS if:

- you pay a service provider less than \$600 a year
- the services were performed for you personally and not for your business
- the independent contractor is incorporated (and can prove it), or

- the work was done by foreign nationals in their own country (outsourcing).

See “IRS Filing and Payment Requirements for Employers,” below, for the filing deadlines and details on reporting workers to the IRS.

Using an independent contractor saves time and expense because IRS reporting requirements are easier to comply with than for employees. It also saves money—owners don’t have to pay the employer’s share of the FICA contributions of 7.65% for each worker. You won’t have to pay unemployment compensation tax (FUTA) either.

But the IRS is very aware of the benefits of misclassifying an employee as an independent contractor, and has wide powers to make life miserable for all those it catches doing it.



TIP

Are business owners employees? Solos, LLC members, and partners are neither employees nor independent contractors. Instead, they mail quarterly estimated taxes to the IRS. (See “Estimated Taxes: Pay as You Go” in Chapter 6.) However, working shareholders/owners of corporations—C or S corporations—are employees and subject to payroll tax rules.

Worker Classifications

Many employers mistakenly believe that a short-term worker is not an employee. Maybe, but whether part-time or temporary, called a consultant or subcontractor, a worker must fit into one of the four tax categories discussed below.

Employees

Anyone performing services controlled by an employer (that is, what work will be done and how it will be done) is legally a common law employee, or just plain employee. Even if an employer doesn’t actually exercise control, but has the legal right to control the method and result of the work done, there’s an employer-employee relationship.

Here are more factors that tend to show the IRS a worker is a common law employee:

- The worker follows instructions about when, where, and how to work.
- The worker is trained by the employer to perform services in a particular manner.
- The worker’s services are integrated into the business operation, or a continuing relationship exists.
- The worker renders services personally (can’t subcontract work out to someone else).
- Assistants are hired by the business, not the worker.
- The worker has set hours.
- The worker devotes substantial time to the employer.
- Work is done on business premises.
- The worker submits reports regularly.
- The worker is paid by the hour, week, or month, unless these are installments of a lump sum amount agreed to for the job.
- The business pays the worker’s business or travel expenses.
- The business furnishes tools, equipment, and materials.
- The business can fire the worker, and the worker has the right to quit, at will.

Independent contractors

Folks in business for themselves and not subject to control by those who pay them are independent contractors or freelancers, not employees.

When you hire an independent contractor to accomplish a task for your business, you don’t have an employer-employee relationship and, therefore, don’t have to withhold and pay employment taxes. Independent contractors are responsible for their own tax reporting and are treated as business owners themselves.

The IRS says these factors tend to show a person is an independent contractor:

- The worker hires, supervises, and pays his or her own assistants.

- The worker is free to work when and for whom she or he wants.
- The work is done on the worker's premises.
- The worker is paid by the job or on straight commission.
- The worker has the risk of profit or loss.
- The worker does work for several businesses at one time.
- The worker's services are available to the general public.
- The worker can't be terminated early, except for breach of contract.

See IRS Publication 15A, *Employer's Supplemental Tax Guide*, for more help on distinguishing independent contractors from employees.

Statutory employees

Federal law automatically classifies some workers as statutory employees. (IRC § 3121(d)(3).)

Statutory employees have taxes withheld by their employers. This unusual tax category covers:

- corporate officers who provide services to the corporation
- delivery drivers of food, laundry, and similar products, even if they are paid strictly on a commission basis
- full-time, business-to-business salespeople, paid on commission—such as manufacturer's representatives and other traveling salespeople who do not sell directly to the public
- full-time life insurance agents working primarily for just one company, and
- home workers who do piecework according to a business's specifications and are provided the materials.

EXAMPLE: Mary is an on-the-road salesperson for RoofCo, a roofing materials manufacturer selling to building contractors. She works out of her car and an office at home, visiting the

RoofCo headquarters only twice a month to pick up samples and commission checks. RoofCo has little control over how and where Mary does her work. Although her work meets some requirements of an independent contractor, Mary is a statutory employee.

Employers must issue W-2 forms to statutory employees; however, they can deduct their business expenses, like independent contractors.

A statutory employee reports wages and expenses on Schedule C, the same form used by sole proprietors.

Statutory nonemployees

The fourth tax code category for working people is the statutory nonemployee, sometimes also called an exempt employee. (IRC § 3508.) Statutory non-employees are treated as independent contractors and are not subject to tax withholding.

This classification covers only two types of salespeople:

- licensed real estate agents working on commission only, and
- direct (to the customer) sellers of consumer products—if the sales take place somewhere other than a retail store or showroom.

Statutory nonemployees report income and expenses on Schedule C, the same as sole proprietors. See “How Solos Are Taxed” in Chapter 7.

A statutory nonemployee's income is directly related to sales—not to hours worked. Typically, they are paid based on a percentage of their sales.

EXAMPLE: Lorenzo operates About Face, a wholesale cosmetics business, and reports that his salespeople are statutory nonemployees. This will stand up to an IRS audit as long as all sales are made off Lorenzo's premises, sales are to consumers of the cosmetics, and the salespeople are paid strictly on commission.

Misclassifying Employees as Independent Contractors

Small businesses often run up against IRS auditors by calling their workers independent contractors instead of employees. The interests of the business owners and the IRS are diametrically opposed: The IRS wants to collect employment taxes for as many workers as possible, and the business owner wants to avoid employment taxes.

Indeed, a small business can save a bundle by not classifying workers as employees. According to the U.S. Chamber of Commerce, it costs a business 20% to 40% more per worker to treat them as employees.

How the IRS Finds Out

If your business is audited for any reason, the IRS looks at payments made to independent contractors.

The *Wall Street Journal* reported that in one six-year period, the IRS performed more than 11,000 audits of companies using independent contractors. The results: 483,000 reclassifications of independent contractors to employee status and \$751 million in back taxes and penalties. Ouch!

Also, special IRS teams search for misclassified workers under the ETE (employment tax examination) program. Typically, these ETE audits focus on industries where they suspect abuses. Recent targets include temporary employment agencies, nursing registries, and building contractors. Enterprises can also be selected for filing many Form 1099s for independent contractors.

The IRS is very selective in its enforcement of work classification rules. It picks on small businesses, while major corporations often flout the worker classification rules. Some of the largest employers frequently hire independent contractors. These Fortune 500 giants furnish offices, require regular work hours, and treat

these so-called independent contractors like their regular employees—except they do not pay employment taxes or give the workers any benefits.



CAUTION

State employment tax agencies can also penalize you. If a worker who was misclassified as an independent contractor is laid off and makes a claim for unemployment benefits, it triggers a state agency inquiry. If the state reclassifies a worker as an employee, the business owner will owe state payroll taxes plus penalties. The state may also turn the employer in to the IRS or vice versa.

Penalties for Misclassifying Workers

The IRS can order offenders to pay all employment taxes that should have been paid, plus a penalty ranging from 12% to 35% of the tax bill.

EXAMPLE: Ray, who wholesales American-made bathing suits, faces stiff competition from cheap imports. To survive, he must keep prices low by cutting overhead to the bone. Ray decides to call his secretary, warehouse person, delivery person, and two inside salespersons independent contractors. Here's what he stands to save:

- Administrative work—filing quarterly tax-reporting forms, withholding employees' pay, and making federal tax deposits.
- Social Security and Medicare taxes. (With independent contractors the employer does not pay 7.65% of their wages as Social Security and Medicare taxes.)
- Federal and state unemployment tax costs.
- Nontax expenses, like workers' compensation insurance, and employee benefits, such as sick leave and vacation pay.

The problem is that Ray's workers are likely to be employees, not ICs.

IRS Classification Settlement Program

The IRS offers an olive branch to small business owners found misclassifying employees. It's called the Classification Settlement Program (CSP). This is a relatively inexpensive way to come clean by making a CSP deal.

To qualify for the CSP, a business owner must:

- have an open case with the IRS, either in an audit or in appeals
- specifically request a CSP deal, and
- be in compliance with § 530 of the 1978 Revenue Act (known as the safe harbor rule). That means an employer must have:
 - filed all tax returns, including Form 1099s showing independent contractor payments
 - treated all similarly situated workers as independent contractors
 - had a reasonable basis for misclassification, such as reliance on court decisions, IRS rulings, or written IRS advice; a past audit that resulted in no employment tax liability for workers in positions substantially similar to the workers

Qualifying employers will be offered one of three settlement deals:

- Past misclassifications won't be assessed taxes.
- The most recent year of taxes for misclassifications must be paid and the IRS will forget about prior years.
- 25% of the latest audit year deficiency must be paid.

In addition, employers must agree to classify the workers as employees in the future. The IRS will monitor your business for five years to make sure you don't fall back into your old ways.

Which one of the three deals you get depends on the judgment of the auditor or appeals officer—and your ability to convince them you acted reasonably. Excuses that may work: reliance on the advice of an attorney or accountant; industry practice, even if not widespread; or your misinterpretation of the 20 factors used by the IRS to determine if a worker is an independent contractor.

EXAMPLE: The IRS audits Ray and reclassifies his secretary, Faye, as an employee. Faye was paid \$20,000 per year for the past three years. Ray's audit bill, with interest and penalties, could be as much as \$30,000 if the auditor decides that Ray intentionally disregarded the law. If, however, the IRS auditor concludes Ray made an innocent mistake, the tax bill would be about \$15,000. Either way, it is a lot of money.

Avoiding Trouble With the IRS

To avoid having the IRS reclassify your independent contractors as employees, they should:

- be paid by the job, not by the hour
- work off your premises in most cases
- hold business licenses and workers' compensation insurance coverage (if applicable), and
- have a written agreement spelling out the terms of the relationship and acknowledging they are independent contractors.

If an IRS auditor attempts to reclassify your worker as an employee, a written agreement with the contractor may win the day. It won't help if the worker is obviously an employee, but it can be persuasive in borderline situations.

In the agreement, the worker should acknowledge a contractor status and should spell out his or her responsibilities. (Pay attention to the IRS list of factors above.) Include a clause stating that

all payments to the contractor will be reported to the IRS on Form 1099 and a Form W-2 will not be used.



TIP

Develop your own form IC agreement.

If you plan to regularly hire independent contractors, develop form contracts and require all contractors to sign one before they start working for you. (See a tax pro or the list of resources at the end of this chapter for independent contractor agreement forms.)



CAUTION

When in doubt, issue a Form 1099. Some workers will tell you it isn't necessary to give them a Form 1099. Unless they have formed a business entity, like a corporation, chances are they aren't playing it straight with Uncle Sam. The IRS can penalize you \$50 for each Form 1099 not issued if you pay more than \$600 in the year to an individual. Far worse, you can be assessed all of the income taxes not paid on the earnings from you for each individual not given a Form 1099. There is no penalty for filing a Form 1099 when not required, so if in doubt, file one for each contractor. If you have questions on issuing a Form 1099 (or a W-2 Form) call a special IRS number: 304-263-8700. These forms are available online at www.irs.gov and in many tax software programs.

Leasing Temporary Employees

Some businesses sidestep employee classification challenges—and save on employee fringe benefits—by leasing temporary workers. The lease company, not you, withholds and does payroll tax reporting. It is all legal as long as you deal with a bona fide employee leasing company.

Weigh whether the cost markup of leasing is worth any fringe benefit or administrative savings for your business. Generally, this idea makes economic sense only for larger businesses with fluctuating needs for workers.

Asking the IRS to Classify Your Workers

If you are in doubt as to how to classify a particular worker, you can have the IRS determine the worker's status. You do this by sending to the IRS Form SS-8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. Be warned, however, that the IRS is very likely to rule them employees. Additionally, the IRS may not respond for several months, which is too long for most small-time operators to wait.

Think twice before you ask the IRS to classify workers. Submitting Form SS-8 puts you on file with the IRS. This can work against you if you decide not to follow the IRS's determination and are audited. However, you may still contest the IRS classification at an IRS appeals hearing or in court.

Appealing a Ruling That You Misclassified Workers

Because the IRS is biased toward finding workers to be employees, business owners often lose on classification audits.

Fortunately, just as with any audit issue, you may appeal. (See Chapter 20 on how to appeal an IRS ruling.) You may even appeal a classification issue before the rest of the audit of your business is complete. (Rev. Proc. 96-9.) And, you may challenge a reclassification of your workers in the U.S. Tax Court. (IRC § 7436.)

There are four good grounds for winning your appeal:

- The IRS auditor didn't properly consider all of the factors.
- The safe harbor rule may apply. Even if the IRS properly classified a worker as an employee, you can claim industry standard relief—which means you classified the worker the same as at least 25% of the other

businesses in your industry. (Section 530 of the Revenue Act of 1978.)

- Raise the previous audit defense if you were audited at any time in the past and no IRS challenge was made to how you classified your workers—assuming you are still in the same line of business with similar workers.
- Offer to treat the disputed workers as employees in all future years, if the IRS will forget the past years. This deal offer might be accepted if your workers are in a gray area and the appeals officer believes that you might win in court. (For more on negotiating strategy, see Chapter 21.)

IRS Filing and Payment Requirements for Employers

The IRS and states require a lot of form filing by employers. If you fail to file a required form—or file it late—at the very least you'll get annoying inquiries, and, at worst, expensive penalties. Missing a due date will almost certainly cost you extra. This is a good reason for using accounting software with a payroll feature, or if your business can afford it, hiring a payroll tax service.

You meet the due date if the form is properly addressed, mailed, and postmarked on or before the due date. For deadlines on a weekend or legal holiday, the next business day is okay.

See your tax pro or use a payroll tax service for help with filing requirements. Get IRS Publication 15 and tax forms from your local IRS office, by mail by calling 800-829-FORM (3676), or online at www.irs.gov. See Chapter 23.

Here are the key tax dates:

- **Each payday: Withhold income taxes and employees' share of Social Security and Medicare.** See “What Are Payroll Taxes?” above. No separate report needs to be made to the IRS at the time of the withholding. (Make federal tax deposits either quarterly,

monthly, or more often, depending on the size of your payroll.)



CAUTION

Late tax deposit penalties are severe.

The IRS charges a penalty of 2% for tax deposits made one to five days late, and up to 15% for payments not received within ten days of an IRS notice and demand. For example, the penalty on a \$3,000 late deposit ranges from \$60 to \$450.

- **Every January 31: Report W-2 and 1099 payments to workers; file your FUTA return.** January 31 is the deadline for mailing workers either a Form W-2 to report wages paid for the prior year or Form 1099-MISC for independent contractor payments to individuals (\$600 or more only).

Send copies of the 1099s and W-2s to the IRS, along with Form W-3, by February 28.

Also, Form 940 (or 940-EZ), *Employer's Annual Federal Unemployment Tax Return (FUTA)*, is due on January 31, along with payment of any balance due.

- **Every February 28: Send copies of Forms 1099 (and 8027) to the IRS.** Mail copy “A” of any Form 1099 you issued on January 31, along with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, to your IRS Service Center. For service businesses, also file Form 8027, *Employer's Annual Information Return of Tip Income*, if your employees receive tips.
- **Every February 28: Send copies of Forms W-2 to the Social Security Administration.** Mail copy “A” of all the Forms W-2 you issued, along with Form W-3, *Transmittal of Wage and Tax Statements*, to the Social Security Administration (address is on the forms). Alternatively, you may file electronically. Go to the Social Security Administration, www.ssa.gov/employers, for more information.

**CAUTION**

Don't be late with your 1099 forms. You can be fined from \$15 to \$50 for each 1099 form that you file late or fail to file. If you need extra time to file your 1099s for any reason, file IRS Form 8809 to request an extension.

**RESOURCE**

Questions about all this? The IRS has a hotline for payors with questions about W-2 and 1099 forms: 866-455-7438.

Record Keeping for Your Workers

Keep permanent records on workers—whether employees or independent contractors—who provide services to your business. The IRS and state tax agencies can demand to see employment records as part of a regular audit or special employment tax audit. Basic employer records should include:

- names, addresses, Social Security numbers, occupations, and dates of employment for everyone paid for their services
- amounts and dates of wage and pension payments to workers
- fringe benefits and goods or services provided to workers (in addition to cash)
- employee tips reported (if applicable)
- Forms W-2 and 1099 copies showing payments to workers, including any that were returned by the post office as undeliverable
- income tax withholding certificates completed by each worker (Forms W-4)
- federal and state payroll tax deposit forms with dates and proof of payment (deposit slip, canceled check, or financial institution receipt)

- federal Forms 940 (annual) and 941 (quarterly) and corresponding state payroll tax forms
- your individual or business income tax returns on which payments to workers were claimed, and
- FICA (Social Security and Medicare) and FUTA (unemployment) taxes paid for each worker.

Checklist for Employers

- ☐ Obtain a federal employer identification number by filing IRS Form SS-4 (if you don't already have one).
- ☐ Register with your state's employment department and make payments of unemployment compensation taxes.
- ☐ Have each employee fill out IRS Form W-4, *Employee's Withholding Allowance Certificate*, and keep them on file.
- ☐ Set up a payroll system for withholding taxes and making regular payroll tax deposits or hire someone to do this.
- ☐ File IRS Form 941, *Employer's Quarterly Federal Tax Return*, after the end of each quarter.
- ☐ File IRS Form 940 or 940-EZ to report your federal unemployment tax after the end of each year.
- ☐ File a Form W-2 for each employee annually to report wages to the IRS and state.
- ☐ File a Form 1099-MISC to report payments to each independent contractor paid over \$600 per year.
- ☐ Familiarize yourself with the difference between independent contractors and employees. IRS and state auditors are on the alert for businesses that misclassify workers as independent contractors, and they can levy heavy penalties on violators.

Resources

- IRS Publication 505, *Tax Withholding and Estimated Tax*. This 48-page booklet greatly expands on the information in this chapter.
- IRS Publication 509, *Tax Calendar*.
- Notice 931, *Deposit Requirements for Employment Taxes*.
- IRS Publication 15A, *Employer's Supplemental Tax Guide*. Every employer should be familiar with this publication; it shows how to fill out employment tax forms.
- IRS Publication 15, Circular E, *Employer's Tax Guide*. This is a useful booklet with forms and charts for determining how much to withhold from employees' paychecks if you do not use an accountant or payroll service.
- IRS Publication 966, *Electronic Choices to Pay All Your Federal Taxes*.
- IRS Publication 3151-A, *Understanding Federal Tax Deposits*. Highly recommended.
- *Working With Independent Contractors*, by Stephen Fishman (Nolo). Everything you need to know about federal and state laws for working with independent contractors.
- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book should be helpful in contesting IRS decisions.
- *The Employer's Legal Handbook*, by Fred Steingold (Nolo). This book details all of the legal issues involved with being an employer.
- IRS forms and publications. Call 800-829-3676 to order current and prior year tax forms, instructions, and publications. There's no charge, and you should receive your order in about ten days. Alternatively, download the latest forms from the IRS's website at www.irs.gov.
- SSA wage reporting specialist. If you have a wage reporting problem, call 800-772-1213 for help.
- Social Security Administration website. For SSA-related information, go to www.ssa.gov/employers.

Sole Proprietorships—Solos, Freelancers, and Independent Contractors

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“The most enlightened judicial policy is to let people manage their own business in their own way.”

—Oliver Wendell Holmes, Jr.,
U.S. Supreme Court Justice

What the heck is a sole proprietorship anyway—something from Merry Olde England? Well, if you’re a self-employed small business guy like me, chances are seven in ten that you are one. A sole proprietor, or solo for short, is what the IRS calls any individual who owns and operates a business that isn’t a formal entity like a partnership or corporation. No wonder most folks choose flying solo; it is the easiest, fastest, and cheapest way to go in (and out) of business.

Solos are known by more familiar handles like self-employed, freelancer, independent contractor, small-time operator, or one-man band. Solos provide services ranging from teenage babysitting to technology consulting to cosmetic surgery. Or, solos may sell costume jewelry on eBay, motorcycles at a shop, or vacuum cleaners door to door. (If you’re a microbusiness or home-based business, make sure you read Chapter 14, too.)

What It Means to Be a Solo— From a Tax Perspective

A solo and his or her business are one and the same in the eyes of the IRS. The profits (or losses) from the operation are reported on the individual’s annual tax return—good old Form 1040—that everyone files April 15. At last count, 20 million people reported doing business as sole proprietors.

Start a solo simply by putting out the word—a website, an ad, or just hanging an “open” sign in the door. No permission or any formalities are necessary for the IRS to become your silent solo

partner. As long as you’re doing whatever it is in hopes of making money, you’re “in business.”

Of course, your state or local governments might want you to get various business or occupational licenses (aka taxes), but these niceties are of no concern to Uncle Sam.

What distinguishes solos from other forms of doing business, like a corporation, is that other business entity forms require their own tax returns. Those details are for later chapters of the book.

To Be or Not to Be—A Solo

Here’s a short list of some pros and cons of being a solo. This is just to get the ball rolling. We’ll discuss these in more detail in this chapter and throughout the book.

Pros

- tax rules are simplest
- no (or minimal) set up costs
- easy to go in and out of business
- you keep all the profits
- easy to change to another business entity form (like a partnership)
- easiest record keeping.

Cons

- you have sole responsibility (no one to share burdens)
- Self-employment tax is double the FICA tax paid by wage-earners
- no co-owners allowed (except maybe a spouse)
- unlimited personal liability for business debts
- audit rates are higher than for other business forms
- Solos die with the owner.

Solo Income and Expenses

Now let's take a look at what income and expense mean for a solo.

Income

An item of income is obvious, right? Not always, according to your favorite uncle, Sam. Income is a very broadly defined term. It includes anything of value that your business gets in return for goods or services.

EXAMPLE: Sarah hires Angelo for \$300 to build shelves in a storage room for her. Angelo notices some neat stuff in Sarah's inventory and they make a deal that he'll build the shelves for \$150 in cash and a poster of Houdini that he liked. How much income should Angelo Solo report? Answer: \$300. He received \$150 in cash and "barter" income of \$150. (Chapter 2 has details on what is and isn't income for a solo.)

Expenses

The primary rules of business deductions apply whether you're Sarah Solo or Mega Corporation: Expenses that are "ordinary and necessary" for your profit-seeking ventures are deductible. Expense types and rules are covered throughout the book, starting in Chapters 2 and 3. Here's a recap for solos:

The ten most common solo tax deductions are:

- vehicles used for business and pleasure—depreciation, gas, insurance, and maintenance
- tax advantaged retirement savings plans, like IRAs and SEPs (see box below)
- equipment—computers, machinery, furniture
- home office expenses—utilities, furnishings, maintenance, rent, or depreciation

Best Solo Tax-Advantaged Retirement Plans

A not-to-be missed solo tax break you can claim every year is for contributions to a retirement plan. And, the tax-deferred compounding of investment in the plan until you make withdrawals makes these even sweeter. Funding your future is good common sense. See Chapter 16 for details on all types of plans, but in summary, the plans most solos choose are:

- **SEP-IRA.** Allows up to 25% of net income to be contributed up to \$49,000. *Pro:* They are a snap to open and are best for one-person biz with no employees. *Con:* Owners must contribute for all employees, not just the boss.
- **Solo 401(k).** Can contribute and deduct up to \$49,000 (plus \$5,500 if over 50). *Pro:* Good for a business with good cash flow and employees. Allows loans. *Con:* Costlier to set up and maintain than other plans.
- **SIMPLE IRA.** An \$11,500 annual contribution limit (plus \$2,500 if over 50). *Pro:* Very easy to set up and works with or without employees. *Con:* Contribution limit may not result in a big enough retirement payoff.
- **Roth IRA.** Not as good in the short term as the three above, as Roth allows only a nondeductible contribution of up to \$5,000 (\$6,000 if over 50). Best for younger solos with lower income levels or higher earners who have maxed out contributions to other plans. *Pro:* No tax when contributions removed from the plan. *Con:* Nondeductible and low contribution limits won't provide much in your golden years, unless you start it young.

- professional fees—tax pros, lawyers, bookkeepers
- employee wages and independent contractor payments
- entertainment and meals—for clients, customers, and employees
- travel—local and long distance
- education to improve your skills—books, trade shows, seminars, and
- health insurance.

Make sure you read Chapter 2 and Chapter 3 for the tax deduction rules and Chapters 15 and 16 for more on fringe benefits and retirement plans.

Business Income Minus Expenses: What's Left Gets Taxed

Not quite as simple as it sounds. Congress adds several twists that usually surprise the Sarah Solos when they file their first tax return.

Twist number one. Solos are taxed on all business profits in the year they are earned. So? This means Sarah Solo is taxed whether she takes all the profits out of her business bank accounts or not. So why wouldn't she take the profit out? Typically, entrepreneurs need to retain some funds to grow, often to build an inventory of goods for sale. Sarah Solo can build her inventory, but since her costs of goods offered for sale are not tax deductible, she must use after-tax dollars to do it.

Twist number two. Solos pay the federal self-employment tax (SE) on their business profits. The SE tax is a combo of Social Security and Medicare taxes that adds 15.3% of the first \$106,800 of a solo's net profit and 2.9% of everything else onto the solo's tax bill. For 2011, the SE tax rate was lowered by 2% to 13.3%. While technically the SE tax is not an income tax, it still comes out of the solo's pocket.

EXAMPLE: Sarah Solo made a net profit (after all expenses) of \$150,000 in her sideline business, Mystical Mania. Sarah took \$75,000 out of the Mystical Mania bank account for living expenses and spent the other \$75,000 of profit on new carpets. Sarah owes income tax of \$37,500 on the \$150,000 sideline income. (Assuming she's in the 25% tax bracket after her personal deductions and exemptions are subtracted from her total income.) And, Sarah's self-employment tax is calculated as 13.3% (2011 rate) on the first \$106,800 (\$14,204) and 2.9% on the balance of \$43,200 (\$1,253), for a total of \$15,457. Grand total: \$52,957. If she lives in a state with an income tax, she'll owe their tax guys too.

Tax savings opportunities. If this sounds like our friend Sarah is paying a lot of taxes, don't fret. We'll show throughout the book how solos can trim the fat from a big tax bill. If you started at Chapters 2 and 3, you know that Sarah can reduce her tax tab by maximizing her deductions. In Chapter 15, we go over how Sarah can save even more by using fringe benefits. A home office deduction can save Sarah even more (see Chapter 14).

Solos' Tax Forms: Schedule C Is Your Friend

No prior notice has to be given to the IRS that you've opened up a sole proprietorship. Your official business ID number is your Social Security number, unless you hire an employee. In that case, you need an Employer Identification Number too. Here are the federal tax forms a solo needs to be aware of:

Schedule C (Schedule F for Agricultural Solos)

Solos report their income and expenses on IRS Schedule C, *Profit or Loss From Business (Sole Proprietorship)*. (Or in some cases, filed with the simplified Schedule C-EZ, discussed below.) This is a separate form filed with Form 1040, everyone's personal income tax return.

We're not trying to make a tax preparer out of anybody. Whether you tackle your own tax return or hire help is your choice. In either case, you should get a general familiarity with Schedule C, paying close attention to the deductions list. Come April 15, this will help keep money in your pocket. Let's walk through the Schedule C key sections—a sample form appears below.

- **Occupation.** Start by noting line B at the top asking for your occupation or business code. This six-digit number shows the IRS what trade you are engaged in; for instance 541213 is for Tax Preparation Services. Exactly what the IRS does with this data is unknown, but at least part of the reason for asking is for audit potential scoring. (See Chapter 20 if audits concern you.)
- **Accounting.** Line F asks you to check mark your “accounting method.” It will almost always be “cash” unless you have an inventory of goods for sale. (See Chapter 4 for details on accounting methods.)
- **Income.** Part 1 “Income” is where you tell the IRS how much you made (or lost) in business. For service providers, like consultants or professionals, this is simple: Lines 1 and the last line (7) will be the same number, as in the sample form.



CAUTION

Add up those 1099 forms. If your business received any 1099-Misc forms, make sure your gross income reported is at least equal to the total amount reported paid to you on the 1099s. It's amazing how

many people don't do this, and then wonder why the IRS computer picked them for an audit. Some folks think they can “net out” the expenses related to the 1099 income and only report the profit. Not so. The expenses for all jobs must be reported on Schedule C. And, the IRS says that 57% of solos underreport their income on Schedule C, so keep good records in case of an audit.

- **Sellers.** For sellers or manufacturers of goods it gets more involved. You are directed to complete Part III, “Cost of Goods Sold.” Essentially, this means you are buying materials used in making a finished product. Show your production costs and enter this figure on line 4 of Part I to come up with Gross Profit on line 5. In our sample below, this section is blank because the filer, John Stephens, is a service provider.
- **Inventory.** If you maintain an inventory of goods for sale, fill in a figure for the beginning of the year (or when you started business, if midyear) and at the end of the year in Part III. Line 6 entries are rare for a solo, so this shouldn't be a concern.
- **Expenses.** Part II, “Expenses,” is the meat of Schedule C for solos. This is where you list all your deductions and tax write-offs, including a home office (at the bottom of the form). Make yourself familiar with this list of deductions. Every one is an income and self-employment tax-cutter!
- **Category of expenses.** This section starts with line 8, “Advertising,” and continues listing common business expenses to Line 26, “Wages,” ending with “Other expenses.” These 27 magic lines cover every deduction category allowed by law. (This is all covered in detail in Chapters 2 and 3.) Line 28 is the expense total, with one exception, next.
- **Home office.** Add in line 30, if you have a home office. (This deduction and related form are explained in Chapter 14.) In our sample below, the filer, John Stephens,

Sample Schedule C—page 1

SCHEDULE C (Form 1040) Department of the Treasury Internal Revenue Service (99)		Profit or Loss From Business (Sole Proprietorship) ▶ Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B. ▶ Attach to Form 1040, 1040NR, or 1041. ▶ See Instructions for Schedule C (Form 1040).		OMB No. 1545-0074 20XX Attachment Sequence No. 09	
Name of proprietor <u>John Stephens</u>		Social security number (SSN) <u>465 00 0001</u>			
A Principal business or profession, including product or service (see instructions) <u>Tax Preparation</u>		B Enter code from pages C-9, 10, & 11 ▶ <u>5 4 1 1 2 3</u>			
C Business name. If no separate business name, leave blank. <u>Stephens Tax Service</u>		D Employer ID number (EIN), if any			
E Business address (including suite or room no.) ▶ <u>821 Union Street</u> City, town or post office, state, and ZIP code <u>Hometown, IA 52761</u>					
F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶					
G Did you "materially participate" in the operation of this business during 2010? If "No," see instructions for limit on losses ☒ Yes ☐ No					
H If you started or acquired this business during 2010, check here ▶ ☐					
Part I Income					
1 Gross receipts or sales. Caution. See instructions and check the box if: • This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or • You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see instructions for limit on losses.					
					▶ ☐
2 Returns and allowances		1	34,280		
3 Subtract line 2 from line 1		2	0		
4 Cost of goods sold (from line 42 on page 2)		3	34,280		
5 Gross profit. Subtract line 4 from line 3		4	0		
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)		5	34,280		
7 Gross income. Add lines 5 and 6		6	0		
		7	34,280		
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising	8	250	18 Office expense	18	600
9 Car and truck expenses (see instructions)	9	1,266	19 Pension and profit-sharing plans	19	
10 Commissions and fees	10		20 Rent or lease (see instructions):		
11 Contract labor (see instructions)	11		a Vehicles, machinery, and equipment	20a	
12 Depletion	12		b Other business property	20b	
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	3,100	21 Repairs and maintenance	21	
14 Employee benefit programs (other than on line 19)	14	750	22 Supplies (not included in Part III)	22	253
15 Insurance (other than health)	15		23 Taxes and licenses	23	
16 Interest:			24 Travel, meals, and entertainment:		
a Mortgage (paid to banks, etc.)	16a	200	a Travel	24a	310
b Other	16b		b Deductible meals and entertainment (see instructions)	24b	
17 Legal and professional services	17	350	25 Utilities	25	256
			26 Wages (less employment credits)	26	
			27 Other expenses (from line 48 on page 2)	27	347
28 Total expenses before expenses for business use of home. Add lines 8 through 27		28		7,682	
29 Tentative profit or (loss). Subtract line 28 from line 7		29		26,598	
30 Expenses for business use of your home. Attach Form 8829		30		1,462	
31 Net profit or (loss). Subtract line 30 from line 29.		31		25,136	
• If a profit, enter on both Form 1040 , line 12, and Schedule SE , line 2, or on Form 1040NR , line 13 (if you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041 , line 3. • If a loss, you must go to line 32.					
32 If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Form 1040 , line 12, and Schedule SE , line 2, or on Form 1040NR , line 13 (if you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041 , line 3. • If you checked 32b, you must attach Form 6198 . Your loss may be limited.					
32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.					
For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11334P Schedule C (Form 1040) 2010					

Sample Schedule C—page 2

Schedule C (Form 1040) 2010

Page **2****Part III** Cost of Goods Sold (see instructions)

33	Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)		
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation	☐ Yes ☐ No	
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs	39	
40	Add lines 35 through 39	40	
41	Inventory at end of year	41	
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43	When did you place your vehicle in service for business purposes? (month, day, year) ▶ / /	
44	Of the total number of miles you drove your vehicle during 2010, enter the number of miles you used your vehicle for:	
a	Business	b Commuting (see instructions)
c	Other	
45	Was your vehicle available for personal use during off-duty hours?	☐ Yes ☐ No
46	Do you (or your spouse) have another vehicle available for personal use?	☐ Yes ☐ No
47a	Do you have evidence to support your deduction?	☐ Yes ☐ No
b	If "Yes," is the evidence written?	☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

Tax education seminar fee	347	00
48 Total other expenses. Enter here and on page 1, line 27	48	347 00

Schedule C (Form 1040) 2010

operates exclusively out of his home office so he doesn't claim any "rent" or "lease" expense on line 20.

- **Net profit or loss.** Your task is to fit every dime you spent fostering your business into one of the categories, listing it all on Schedule C. Add it all up on line 31, "Net profit or loss," to come up with the business net income (or loss). The last step is to transfer this number to the front page of your personal tax return, line 12 (the number at the time this is being written).

Schedule C Special Notes

- **Vehicles.** Part IV, "Information on Your Vehicle," is not what it appears to be at first glance. Note that in our sample Schedule C it is left blank and vehicle expenses are entered on Part II, line 9. Chances are that will be the same with you, even if you use a business vehicle, as did John Stephens in our example. And you will likely also use Form 4562 to claim vehicle depreciation, as explained in Chapters 2 and 3.
- **Other types of expenses.** Part V, line 48, "Other Expenses," is simply a listing of expenses that don't fit in lines 1 to 26. For example, "shipping and postage" or "Internet service provider" charges. Here's your chance to max out your deductions by listing smaller things you might have otherwise overlooked.
- **Agriculture producers and sellers.** Solo farmers, ranchers, and florists have a counterpart form to Schedule C, called Schedule F. While many of the tax rules are the same, there are some significant differences, particularly with deductions. We don't cover Schedule F in this book. My advice is to see IRS Publication 225, *Farmer's Tax Guide*, or find a tax pro that specializes in agricultural businesses.

- **Inventory.** Inventory can be valued in different ways: cost, lower of cost or market value, write-down of subnormal goods, or by using more complex methods called LIFO (last in, first out), FIFO (first in, first out), and Specific Identification. One size doesn't fit all, so you or your tax pro should weigh and consider the most advantageous method taxwise for your specific business. (See Chapter 3.)
- **Depreciation.** Line 13 is for listing your total depreciation and Section 179 deductions for assets purchased for your business. This deduction is calculated and taken on Form 4562. (How to come up with this figure is covered in "Depreciating Business Assets" in Chapter 3.)
- **Travel, meals, and entertainment.** Line 24—this has special rules, which you should be aware of. (See Chapter 2 for details.)

There you have it! For many solos, Schedule C is all that's needed to report your business income and expenses. There are usually a few more required forms (like Form 4562 mentioned above and Form SE discussed below). All of these solo forms are filed with your annual Form 1040 tax return.

Getting Real Simple With Schedule C-EZ

A solo business may qualify for a simplified tax form, Schedule C-EZ. For example, Zelda, who sets up a fortune-telling booth on Sundays at the flea market, may be able to use Schedule C-EZ for reporting her income from *Zelda Who Knows the Future, Past, and Present*. This simplified tax form will work for you if your business has:

- expenses under \$5,000
- no inventory
- no employees
- cash method accounting

- no depreciation or Section 179 write-offs, and
- no operating losses.

While C-EZ may work for Zelda, who has few expenses, most solos have more than \$5,000 in deductions or depreciation deductions or inventory. Don't pass up tax write-offs for the sake of simplicity. It doesn't take much more effort to complete a regular Schedule C.

Other Solo Tax Forms

While Schedule C is the principal tax form a solo must file, there are often a few others, depending on the circumstances. The other most likely forms required for solos are:

- **Home office.** Form 8829 listing home office expenses (see Chapter 14 for an explanation and a sample of this form).
- **Depreciation.** Form 4562 for depreciation deductions or Section 179 write-offs. (See Chapter 3 for an explanation and a sample of this form.)
- **Schedule SE (Self-Employment).** This tax will be due if your solo business made a profit. (See explanation and sample form below.)
- **State income tax.** You will need to file state income tax forms if your state has an income tax (43 of 50 states do).

What If You Have More Than One Solo Venture?

It's not unusual for an individual, or a husband and wife, to have several solos going at once. The IRS says there must be a separate Schedule C filed for each venture. Example: Sarah Solo works for BigBoxMart during the day and has a side biz selling NutriYuck diet supplements to her coworkers. Husband Sammy is an eBay power seller of celebrity-used toothbrushes. Their joint tax return should have two Schedule Cs, or two C-EZs. They are not allowed to file one of each form.

What If My Solo Biz Loses Money?

The cash register doesn't always "ka-ching" for a solo. Take it from someone who's been there—business ventures don't always work out. The U.S. Chamber of Commerce gives you no better than a one in five chance of lasting in the business arena as long as five years. Good news for us losers: the tax code offers some salve for your pain!

Congress, in an uncharacteristically generous spirit, allows a solo's business net operating loss (gross receipts less all expenses) to offset other income—like wages from a job or earnings from another business. To get this tax-cutting deal, solos must file the Schedule C return showing the loss.

EXAMPLE: Sarah Solo earns a \$35,000 salary at BigBoxMart. She loses \$1,500 on her side work selling NutriYuck diet supplements, after deducting expenses for sales aids, samples, and shipping charges. The \$1,500 loss is tallied up on Sarah's Schedule C, and then listed on the front page of her joint tax return, a few lines below her wages from her day job. Effectively, the loss reduces Sarah's taxable earnings by \$1,500. Sarah and hubby, Sam, are in the 25% tax bracket, so the loss saved them \$375 in federal taxes (and maybe state income taxes as well).



CAUTION

The IRS keeps an eye out for business losses. The tax returns that seem to get audited most are those showing a business loss. Not to say that you shouldn't claim a legit loss—just be aware that you have a higher probability than profit-making solos to be asked by the IRS to prove your entitlement to the loss. Knowing this, losers should keep particularly good records.

How Solos Are Taxed

If you're with us so far, you know it all starts with the bottom line from your solo operation—the net profit or loss. This is what appears on line 31 of Schedule C. This number is transferred to page one of Form 1040, your individual tax return. It is then added in with income from all sources: wages from employment, dividends, interest, and capital gains. Then you get to subtract so-called “adjustments,” like retirement plan contributions, alimony, and one-half of SE tax (explained below) to reach your “adjusted gross income” at the very bottom of page one.

Next, on page two of your Form 1040 tax return, you total and subtract your personal exemptions (the ones for you and your dependents just by virtue of breathing). Then, you get to knock off either your itemized deductions (mortgage interest, medical, real estate taxes, and so on) or the standard deduction (flat dollar amount).

The result is what is called “taxable income,” and that's the number that determines your tax liability. How much you owe will depend on your tax bracket—currently ranging from 10% to 35%. Solos owe a separate self-employment tax for Social Security and Medicare, which is discussed below.

EXAMPLE: After adding up all Sarah and Sam's income from solo ventures and Sarah's job at BigBoxMart, and subtracting their exemptions and personal deductions, Sarah and Sam Solo's taxable income on their joint return is \$62,000. Using the IRS tables for this year, their income tax is \$8,521.

Figuring the Self-Employment Tax

Social Security and Medicare contribution. Don't we all hope to be around long enough to collect Social Security and have our doctor bills picked up by Medicare? Here's hoping that there will still be Social Security by the time we all retire—but

that's another issue. The self-employment or SE tax is the solo's way of doing her patriotic duty for these future federal entitlements.

The SE tax rate on solos is 15.3% of all self-employed income up to \$106,800 (2011) and 2.9% for anything over this amount. For 2011, the SE tax rate was lowered by 2% to 13.3%.

EXAMPLE: Sarah quits BigBoxMart and the next year Sarah and Sam Solo earn a combined total of \$78,000 from their solo ventures. The SE tax on this is 13.3% (2011 rate) $\times$ \$78,000: \$10,374. This amount is added on to Sam and Sarah's tax bill before any subtractions are made for adjustments, exemptions, and itemized or standard deductions.

New SE Tax Break for Small Business Owners.

Small business owners are now allowed to deduct the cost of health insurance for themselves and their families before calculating their self-employment taxes. For example, if Spedilla's self-employment income is \$67,000 and she spent \$7,000 for health insurance, the self-employment tax savings would be 13.3% (2011 rate) of \$7,000 or \$931.

Half your SE tax can be subtracted from income.

Congress taketh and Congress giveth back, sort of. Paying the SE tax produces a tax break for solos. The SE tax qualifies for an adjustment to income. Here's how it works. You can subtract one half of your SE tax from your total income on page one of your 1040 tax return. Note that I said “subtract” not “deduct.” Don't confuse this with a business deduction, which is claimed on Schedule C. It's just semantics—here's an example.

EXAMPLE: In her first year of operation, Sarah Solo's self-employment taxes come to \$8,000. Sarah claims one-half (\$4,000) as an adjustment on page one of her tax return, which reduces her gross income by \$4,000. Sarah is in the 25% tax bracket, so this adjustment shaves \$1,000 off her tax bill.

Sample Schedule SE—page 1

SCHEDULE SE
(Form 1040)Department of the Treasury
Internal Revenue Service (99)**Self-Employment Tax**

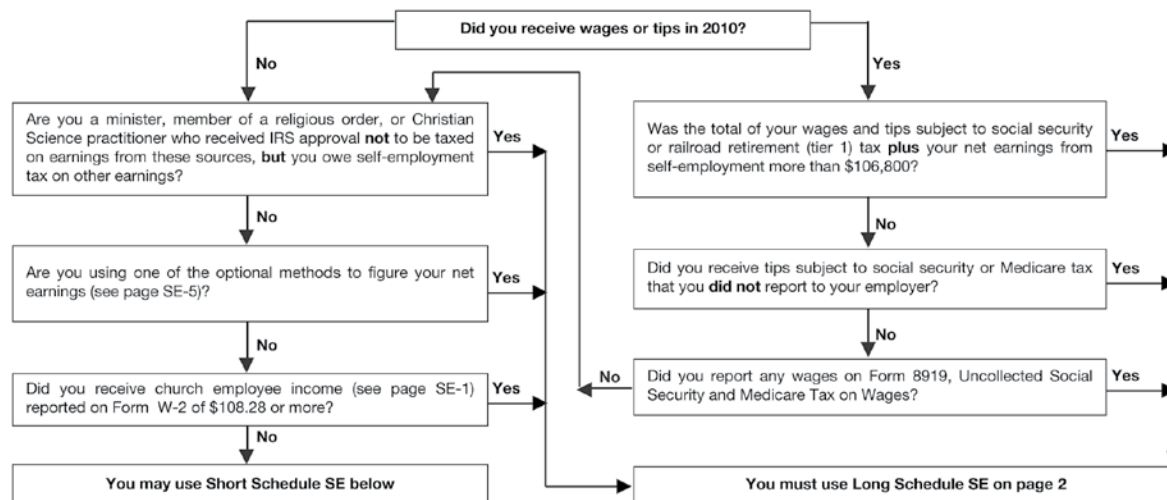
OMB No. 1545-0074

20XXAttachment
Sequence No. **17**► **Attach to Form 1040 or Form 1040NR.** ► **See Instructions for Schedule SE (Form 1040).**Name of person with **self-employment** income (as shown on Form 1040)

John Stephens

Social security number of person
with **self-employment** income ►

465-00-0001

Before you begin: To determine if you must file Schedule SE, see the instructions on page SE-1.**May I Use Short Schedule SE or Must I Use Long Schedule SE?****Note.** Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* on page SE-1.**Section A—Short Schedule SE.** **Caution.** Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a		
1b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 6b, or listed on Schedule K-1 (Form 1065), box 20, code Y	1b	(	)
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for types of income to report on this line. See page SE-3 for other income to report	2	25,136	
3	Combine lines 1a, 1b, and 2. Subtract from that total the amount on Form 1040, line 29, or Form 1040NR, line 29, and enter the result (see page SE-3)	3	25,136	
4	Multiply line 3 by 92.35% (.9235). If less than \$400, you do not owe self-employment tax; do not file this schedule unless you have an amount on line 1b ►	4	23,213	
Note. If line 4 is less than \$400 due to Conservation Reserve Program payments on line 1b, see page SE-3.				
5	Self-employment tax. If the amount on line 4 is: • \$106,800 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 56 , or Form 1040NR, line 54 • More than \$106,800, multiply line 4 by 2.9% (.029). Then, add \$13,243.20 to the result. Enter the total here and on Form 1040, line 56 , or Form 1040NR, line 54	5	3,552	
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.50). Enter the result here and on Form 1040, line 27 , or Form 1040NR, line 27	6	1,776	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2010

Sample Schedule SE—page 2

Schedule SE (Form 1040) 2010		Attachment Sequence No. 17	Page 2
Name of person with self-employment income (as shown on Form 1040)		Social security number of person with self-employment income ▶	123 45 6789

Section B—Long Schedule SE

Part I Self-Employment Tax

Note. If your only income subject to self-employment tax is **church employee income**, see page SE-3 for specific instructions. Also see page SE-1 for the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had \$400 or more of **other** net earnings from self-employment, check here and continue with Part I ☐

1a Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. Note. Skip lines 1a and 1b if you use the farm optional method (see page SE-5)	1a	
b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 6b, or listed on Schedule K-1 (Form 1065), box 20, code Y	1b (	)
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for types of income to report on this line. See page SE-4 for other income to report. Note. Skip this line if you use the nonfarm optional method (see page SE-5)	2	
3 Combine lines 1a, 1b, and 2. Subtract from that total the amount on Form 1040, line 29, or Form 1040NR, line 29, and enter the result (see page SE-3)	3	
4a If line 3 is more than zero, multiply line 3 by 92.35% (.9235). Otherwise, enter amount from line 3 Note. If line 4a is less than \$400 due to Conservation Reserve Program payments on line 1b, see page SE-3.	4a	
b If you elect one or both of the optional methods, enter the total of lines 15 and 17 here	4b	
c Combine lines 4a and 4b. If less than \$400, stop ; you do not owe self-employment tax. Exception. If less than \$400 and you had church employee income , enter -0- and continue ▶	4c	
5a Enter your church employee income from Form W-2. See page SE-1 for definition of church employee income	5a	
b Multiply line 5a by 92.35% (.9235). If less than \$100, enter -0-	5b	
6 Add lines 4c and 5b	6	
7 Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2010	7	106,800 00
8a Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If \$106,800 or more, skip lines 8b through 10, and go to line 11	8a	
b Unreported tips subject to social security tax (from Form 4137, line 10)	8b	
c Wages subject to social security tax (from Form 8919, line 10)	8c	
d Add lines 8a, 8b, and 8c	8d	
9 Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 ▶	9	
10 Multiply the smaller of line 6 or line 9 by 12.4% (.124)	10	
11 Multiply line 6 by 2.9% (.029)	11	
12 Self-employment tax. Add lines 10 and 11. Enter here and on Form 1040, line 56, or Form 1040NR, line 54	12	
13 Deduction for one-half of self-employment tax. Multiply line 12 by 50% (.50). Enter the result here and on Form 1040, line 27, or Form 1040NR, line 27	13	

Part II Optional Methods To Figure Net Earnings (see page SE-4)

Farm Optional Method. You may use this method **only** if (a) your gross farm income¹ was not more than \$6,720, or (b) your net farm profits² were less than \$4,851.

14 Maximum income for optional methods	14	4,480 00
15 Enter the smaller of: two-thirds ($\frac{2}{3}$) of gross farm income ¹ (not less than zero) or \$4,480. Also include this amount on line 4b above	15	

Nonfarm Optional Method. You may use this method **only** if (a) your net nonfarm profits³ were less than \$4,851 and also less than 72.189% of your gross nonfarm income,⁴ and (b) you had net earnings from self-employment of at least \$400 in 2 of the prior 3 years. **Caution.** You may use this method no more than five times.

16 Subtract line 15 from line 14	16	
17 Enter the smaller of: two-thirds ($\frac{2}{3}$) of gross nonfarm income ⁴ (not less than zero) or the amount on line 16. Also include this amount on line 4b above	17	

¹ From Sch. F, line 11, and Sch. K-1 (Form 1065), box 14, code B.
² From Sch. F, line 36, and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method.
³ From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9, code J1.
⁴ From Sch. C, line 7; Sch. C-EZ, line 1; Sch. K-1 (Form 1065), box 14, code C; and Sch. K-1 (Form 1065-B), box 9, code J2.

Schedule SE (Form 1040) 2010

**TIP**

You may not owe SE tax with a one-time job. Here's a bit of relief for any solo who worked only briefly and reports the earnings from this work as "miscellaneous income" (not on Schedule C): The U.S. Tax Court reversed the IRS's effort to impose the SE tax on John Batok, a retiree who installed a few windows in a small office building. The court found this one-time job did not put John in a "trade or business" and so he didn't owe any SE tax. Of course, John had to pay income tax on his window work. (*John A. Batok*, TC Memo 1992-727.) But it probably isn't a good idea to push too hard on this issue. If John had just one more small job that year, the tax court might not have been so understanding.

Estimated Taxes: Pay as You Go

Solos do not have the option to pay their taxes once a year. The IRS figures that by the time April 15 rolls around, the solo's till may be empty, so they have devised a pay-in-advance program.

Solos must pay the IRS four times during the year. These are called *estimated* taxes. These four payments cover both a solo's income and self-employment taxes. The four due dates are not equally spaced apart. The first payment is due April 15, the second on June 15, the third on September 15, and the fourth on January 15 of the following year. If the 15th falls on a weekend the due date is the following Monday.

Solos must try to predict how much they will earn for the year. And, indirectly, how much income and SE taxes they will owe. This must be done as early as 8½ months before the end of the year. (The first estimated tax payment is due on April 15.)

**CAUTION**

Watch out for penalties. If you miss the due date of any quarterly payment, or have underpaid by April 15 of the following year, you'll get a tax penalty. How much you will owe depends on the IRS penalty

rate at the time the quarterly payment was due, and how short you were percentage-wise. For instance, if you skipped the June 15 payment, you could be penalized with an IRS interest charge, which would run from June 16 until it was paid in full (presumably April 15 of the following year). See the IRS website (www.irs.gov) or IRS Publication 505, *Tax Withholding and Estimated Tax*, for current penalty rates and details.

Practically speaking, getting estimated tax payments right is easier if you've been operating a few years. And, for the start-up period, you may have a loss or not enough net income for the penalties to matter. You will never get the figure exactly right, so if you're really concerned about the penalty, or having the money to pay in full on April 15, overpay a little.

Most solos calculate their estimated taxes based on how much tax they paid in prior years. A tax software program like *TurboTax* (see below) uses your prior years' tax to prepare your four new estimated tax reporting forms.

By the time the third payment date rolls around (September 15), you may know how the rest of the year's income is likely to turn out. If income is going to be lower than anticipated when you made the first payment (April 15), then lower or skip your fourth estimated tax payment, or increase it if you underestimated your income.

Small time exception to penalty rules. No estimated tax payments are required if you expect to owe less than \$1,000 for the year, after subtracting any withheld taxes from other employment.

As a rule of thumb, if your business is a small sideline affair and you have wages and tax withholding from a day job and the sideline profit is around \$5,000, you probably will owe less than \$1,000, so you don't have to worry about a penalty for not making estimated tax payments.

Another estimated tax penalty exception. Self-employed folks who pay at least 100% of their prior year's total tax in estimated tax payments are not liable for underpayment penalties. The

only exception is for people who earn more than \$150,000 in the prior year. Those people must pay 110% of the prior year's taxes to avoid the underpayment penalty.

Spouses Who Co-Own Their Business

Married couples who jointly own a business used to have to form a business entity (a corporation or partnership, for example) in order to file their taxes. Now there is an alternative. Spouses who co-own a business can elect to file *two* Schedule C forms each year, with each spouse reporting his or her share of the business's profits (or loss). There can't be any other business owners, such as kids or outsiders. In addition, both spouses must materially participate in the operation of the business (do actual work). This arrangement is called a qualified joint venture.

Going this route means that each sole proprietor spouse must file a separate self-employment tax form (Schedule SE), reporting his or her Social Security and Medicare taxes on his or her share of the business income. There aren't any tax savings, but both spouses do receive Social Security and Medicare credits for their earnings.

How to Make Estimated Tax Payments

Estimated tax payments are made on IRS Form 1040-ES. The IRS sends preprinted forms and payment envelopes to you after your first year of reporting self-employment income. Or, with a software program like *TurboTax*, the forms are prepared and printed out automatically when doing your current returns. It's okay to use either set of forms to make the payments. The *TurboTax* form is shown below.

State estimated taxes. If your state taxes income, it will likely require quarterly estimated tax payments too. Check with your state's tax agency or a tax pro. *TurboTax* also prepares state estimated tax forms.

Solos Hiring Help

Hiring workers means more paperwork, tax forms, and expense. Ask yourself first if you really need employees—or if maybe you could outsource the job to independent contractors (ICs). Either way, there are some extra tax duties, but the IC route is much less trouble.

Form	1040-ES Department of the Treasury Internal Revenue Service	20XX Estimated Tax		Payment Voucher 3 OMB No. 1545-0074				
File only if you are making a payment of estimated tax by check or money order. Mail this voucher with your check or money order payable to the "United States Treasury." Write your social security number and "2008 Form 1040-ES" on your check or money order. Do not send cash. Enclose, but do not staple or attach, your payment with this voucher.				Calendar year—Due Sept. 15, 2011 Amount of estimated tax you are paying by check or money order. <table border="1"> <tr> <td>Dollars</td> <td>Cents</td> </tr> <tr> <td>2,667</td> <td>50</td> </tr> </table>	Dollars	Cents	2,667	50
Dollars	Cents							
2,667	50							
Print or type	Your first name and initial Niles W.	Your last name Crain	Your social security number 444-88-9999					
	If joint payment, complete for spouse							
	Spouse's first name and initial Daphne L.	Spouse's last name Crain	Spouse's social security number 555-33-1111					
	Address (number, street, and apt. no.) 888 Rain Lane							
	City, state, and ZIP code. (If a foreign address, enter city, province or state, postal code, and country.) Seattle, WA 99999							
For Privacy Act and Paperwork Reduction Act Notice, see instructions on page 5.								

If you need help, here's a summary of the federal employment tax reporting rules. For more details, see Chapter 6.

- Get a **Federal Employer Identification Number** (if you don't already have one or have just been using your Social Security number on Schedule C). And, register with your state's employment department.
- Make regular federal payroll tax deposits reported quarterly on **Form 941** at a U.S. Treasury-approved bank. You can make deposits at the bank, or by mail or electronically.
- Report employee wages annually on **Form W-2** with the Social Security Administration, and send a copy to each employee. You must do this each January following the year of employment.
- Report and pay the federal unemployment tax (FUTA) on **Form 940** once a year and pay state unemployment taxes as required by your state.
- Report payments to independent contractors annually on **Form 1099-MISC**.

Remember, solos are owners and not employees, so they must follow the estimated tax rules (discussed above) and deposit tax payments four times a year.

Record Keeping for Solos

Record keeping and accounting get their own chapter in this book (Chapter 4). Here's a quick rehash for solos.

Compared to other ways of doing business, record keeping for solos is the simplest. With that said, poor records are the hallmark of most failed solo enterprises. I'm talking about people who scribble expenses on odd scraps of paper, mix business with personal things, and worst of all, "trust their memories."

Without records, a solo won't know for sure whether he or she is making or losing money—let

alone be able to properly tax report, and defend it all, to the IRS.

Uncle Sam doesn't mandate any particular record-keeping system, just that it be accurate. And, if your enterprise sells items off the shelf, you must keep inventory records. This means tracking your stock and tallying it up at tax year end (almost always December 31 for a solo).

Start-Up Licenses and Permits

Although you don't have to tell the IRS until you've got a tax year of operations under your belt, your state and local governments have their preopening rules and taxes. Before setting up your tent, make sure you have obtained various permits, such as:

- a local business license, permit, or whatever is needed to do business
- a sales tax permit from your state if required for your type of business
- state certifications like professional licenses, vocational licenses, and environmental permits, and
- city or county licenses or zoning variances or conditional use permits to operate in a district or neighborhood.

For more info, see *The Small Business Start-Up Kit*, by Peri Pakroo (Nolo).



CAUTION

Don't mix business with pleasure. Solos run the loosest ships in the small business fleet, and the IRS auditors know it. The no-no found most often here is tagging personal expenses as business deductions. Show the IRS you're not guilty of this by keeping business records separate from personal ones. I'd recommend you buy and use *Quicken* to keep things straight. At an absolute minimum, keep separate checking and credit cards for business use.

You can use the information in the chart below to help determine some of the forms that you may be required to file as a sole proprietor.

When a Solo Closes Up Shop

Just as going solo is easy, it's almost—but not quite—as simple to end things. Just stop operations or put up a “closed for good” sign, fade into the sunset, or slink away into the night.

The tax hitch is when it comes to disposing of—or keeping—any business assets used in your solo venture. Typically, we're talking about items like equipment that you took depreciation tax deductions on in past years. The tax code says there is a taxable gain or loss to report—even if you just stop using them for business and keep them for personal reasons. To see how this might apply to you, go to Chapter 18.

business assets) is large enough, and/or if the solo is not married. (Estate taxes are covered in Chapter 13).

For a small mom-and-pop shop, there's usually no estate tax and maybe not even a probate. In reality, the survivor often just takes over and the business keeps going.

When a surviving spouse (or other heirs) carries on a solo business using the same assets (name, location, equipment, and so on), it's a totally new venture in the eyes of the IRS. The successor to the business should meet with a tax pro to make sure everything is done properly.



RESOURCE

Recommended reading. For more on estate planning for solos, including avoiding probate, see *Plan Your Estate*, by Denis Clifford (Nolo).

Death of a Solo

When a solo business owner dies, the IRS says a solo's business dies as well. Solo assets become part of the solo's estate. There might be an estate tax if the sum total of everything left behind (including

Outgrowing the Solo

While most small business owners happily live and die as solos, others take on partners, incorporate, or form limited liability companies down the road. Tax reasons alone rarely justify

Solos are Liable for:	Use IRS form:
Income Tax	Schedule C or C-EZ and Form 1040
Self-employment tax (Social Security, Medicare)	Schedule SE (annually)
Estimated tax (owners' income taxes)	1040-ES (quarterly)
Social Security and Medicare taxes and income tax withholding for employees	941 or 944 (periodically) 8109 (to make deposits)
Providing information on Social Security and Medicare taxes and income tax withholding for employees	W-2 (to employee) (annually) W-2 and W-3 (to the Social Security Administration)
Federal unemployment (FUTA) tax	940 (annually) 8109 (to make deposits)
Reporting payments to nonemployees and transactions with certain other persons	Information returns, such as 1099, 1098, 5498, and W-2G (annually)
Excise taxes	See the Excise Tax page on the IRS website at www.irs.gov .

going to one of these more complex forms of doing business.

A change in business form is necessary for a solo to bring other folks (other than a spouse) into the venture, or to grow or share the load. A partnership is the most common way to share co-ownership. A corporation or limited liability company adds a shield from personal liability for the businesses owners. In most states, a one-person business can incorporate or form an LLC. (See Chapters 8 and 9.) These are all nontax reasons for changing the ownership form, but they can all have tax implications and traps, as explained in this book.

Before switching, just know that all of these more formal business entities will complicate your tax life. There are costs for tax pros, lawyers, bookkeepers, payroll tax services, and so on. The only saving grace is that all of these extra expenses are tax deductible.

Taxes and Sole Proprietors in a Nutshell

- Sole proprietorships are the simplest way of doing business taxwise.
- A solo is not a separate entity from its owner, so it doesn't file its own tax return.
- Income or loss is reported on Schedule C, with the owner's annual tax return.
- An operating loss of a solo business generally may be used to offset other income and reduce a tax bill.
- Solos pay their income taxes in four installments per year, and a separate "self-employment" tax to cover Social Security and Medicare contributions.
- A solo business ceases to exist when the owner dies, unlike all the other business entity forms.
- Most small businesses begin as solos and stay that way, but some go on to form partnerships, limited liability companies, or corporations.

Resources

The following publications are available on the IRS website (www.irs.gov):

- Publication 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*. This is a must-have, especially for those of you doing your own tax return preparation.
- Publication 225, *Farmer's Tax Guide* (if you are a farmer); Publication 595, *Tax Highlights for Commercial Fishermen* (if you are a commercial fisherman).
- IRS Publication 505, *Tax Withholding and Estimated Tax*.
- IRS Publication 533, *Self-Employment Tax*.
- IRS Publication 15, *Employer's Tax Guide*. This booklet gives a detailed explanation of the payroll tax process and the forms used if your business has employees.
- Publication 583, *Starting a Business and Keeping Records*.

You can also find useful information by typing in the following search terms on the IRS website:

- Other Useful Forms for Sole Proprietorship
- Husband and Wife Businesses
- Business Structures
- Distinguishing Between Self-Employment Individuals and Independent Contractors.

Several good books thoroughly discuss factors to consider when choosing the legal form for your business. Some of the best are:

- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo).
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs).
- *LLC or Corporation? How to Choose the Right Form for Your Business*, by Anthony Mancuso (Nolo).
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinnpcpas.com.

C Corporations

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“You can have a lord, you can have a king, but the man to fear is the tax collector.”

—Sumerian Proverb

The word corporation brings to mind IBM, GM, or AT&T—businesses so big and familiar we know them by their initials.

Corporations don’t have to be huge though; anyone can form one. But should you?

Big business has had a great deal of say in Congress and, as a result, our tax code often favors corporate America. But even small incorporated businesses get some tax breaks unavailable to partnerships, LLCs, and sole proprietorships.

Most corporate tax breaks involve fringe benefits. (See Chapters 14 and 15.) This means that only solidly profitable businesses gain a tax advantage by incorporating. Typically, start-ups don’t reap tax advantages from incorporating, and the simplicity of a sole proprietorship, limited liability company, or partnership works well enough. Later, if a business grows, you can always incorporate (although you probably won’t ever feel the need to do so).

Any tax advantages must be balanced against factors including the more complex tax rules corporations must follow and the legal and accounting costs of a corporation.

A corporation is the most expensive way of doing business. Initial incorporation charges and annual fees to the state are required to maintain a corporation—whether or not it is active or makes a profit. Additional legal and accounting costs can put a significant dent in a new business’s cash flow. Also, professional help will be needed to deal with federal and state tax reporting. This explains why C corporations are the least popular small business entity. Approximately two million C corporations file tax returns annually.



CAUTION

Tax considerations are only one factor in deciding whether to incorporate. For most folks, the personal liability shield a corporation provides is more important than tax considerations. For example, if your building demolition business carries high risks that can’t be adequately covered by insurance, a corporation protects your personal assets (like your home, car, and bank accounts) from business creditors or a court judgment.

Types of Corporations

Small business corporations are classified for tax purposes as either C or S corporations. These two letters refer to subchapters of the tax code (in case you were wondering). This chapter discusses tax treatment of C corporations; S corporations are covered in Chapter 9. The professional corporation is covered in Chapter 12. Nonprofit corporations are beyond the scope of this book.

By default, business corporations begin life as C corporations. After incorporating, the shareholders may choose S corporation status if they want the business owners to be taxed like a partnership instead of a corporation. Read Chapter 9 to fully understand your options. Also, ask your tax pro about the built-in gains tax before changing your corporate status.

Here’s some advice from a small business entity expert, Gene Fairbrother, president of MBA Consulting, Inc.: “Choosing between the C and S corporation depends on the overall expected profits of the business and how much money the shareholders will be taking out in salaries and benefits. The decision also has to take into consideration future business growth plans and maybe even a future sale of the business. Nobody can determine the best legal and tax structure for a business without making a full evaluation of your situation. You need to crunch all the numbers in light of your personal circumstances.”

How to Set Up a Corporation

Small business corporations are chartered by the 50 states, not the federal government. While there are differences in the details, state incorporation procedures are remarkably similar.

Some states, such as Delaware and Nevada, have very low incorporation fees, seemingly making them more attractive than your home state. These two states, as well as Wyoming, do not tax corporations or tax them at low rates. Sound good?

Be warned: Though another state's incorporation rules and tax structure may seem attractive, there is a big catch. For starters, your home state probably requires out-of-state corporations to register and pay a fee before doing business within its borders.

For instance, California charges the same fee for qualifying as an out-of-state corporation as it does for creating a California corporation. So if a California resident forms a Nevada corporation, the corporation must pay two annual corporation fees if the company does any business in California. What's more, any income from the Nevada corporation paid to a California resident is subject to California's state income tax. In this case, there is a tax cost, not a savings, for incorporating out of state.

However, there may be nontax advantages (such as the right not to disclose the names of corporate shareholders in Nevada and Wyoming) to incorporating out of state. Check with a knowledgeable business attorney if you're interested in doing this.

Register your out-of-state corporation. If you are tempted to form a corporation out of state and then do business in your home state without registering, you should know the risks. The back taxes, fees, and penalties your home state might impose can be heavy. Further, many states do not permit out-of-state corporations to sue in their state courts until the foreign corporation registers and pays the required fees. That means if your corporation has a

grievance with someone and needs to sue, you'd be out of luck.

Incorporating is easy. You can do it yourself using software or a self-help book containing forms and instructions. Or, a private incorporation service (check the yellow pages or the Internet) can prepare and file the forms for you. You can hire a local business lawyer (the best—but most expensive—way to go).

First, choose your corporate name (after making sure it is available by checking with your state's corporate filing office). Next, prepare a document called articles of incorporation, often a fill-in-the-blanks form. State the name of your corporation, its address, its general purpose, and the name of the person to be served with legal papers in case of a lawsuit. (Check self-help books, software, or your state's secretary of state or corporations department websites for the forms. Visit www.statelocalgov.net for links to these agencies in your state.)

Send this paperwork to your state's corporate filing office, along with the filing fee: typically \$50 to \$1,000. If you do the paperwork right, you will get back a corporate charter and, congratulations, you're incorporated.

Next, hold a first meeting of stockholders, adopt bylaws (rules that govern the corporation's operation), and appoint officers and directors. If you're doing it yourself, use fill-in-the-blanks bylaws forms or a software program. Corporate kits with blank stock certificates and form minutes of corporate meetings are widely available at bookstores and on the Internet. After the initial meeting, you must hold annual meetings of shareholders and directors to maintain your legal status as a corporation.

Keep a corporate records book. Records help prove to the world (including an IRS auditor) that you really are a corporation. Otherwise, you may lose any benefits of corporate status.

**CAUTION**

This chapter covers tax issues for small business corporations only. This means corporations with few shareholders, where shareholders play an active role in running the business and where the shares are not readily transferable. This book is not intended for large publicly traded corporations.

How C Corporations Are Taxed

A corporation can own property, enter into contracts, borrow money, and sue and be sued, just like a person. It is a tax reporting entity distinct from its owners, who are called stockholders or shareholders.

Corporations may have many or just one stockholder. With just one stockholder, that person can also be the sole director as well as the president, and take on other corporate offices as well, like secretary and treasurer.

**CAUTION**

Shareholders who work in the corporation are its employees. A shareholder of a corporation who is active in the business is not self-employed in the eyes of the tax law. Consequently, throughout this chapter, the term employee usually includes owners (the shareholders).

EXAMPLE: Sam Smith and his wife Jeannie incorporate Smith's Computer Sales & Service. All stock is owned by Sam, Jeannie, and two key employees.

The Smiths and their corporation are now separate taxpayers, and both must file their own tax returns. This is a huge change from when Sam was a sole proprietor; then Sam and his business were legally one and the same and there was only one tax return.

Double Taxation of Profits

A C corporation follows federal and state income tax rules that are different from those for sole proprietorships, limited liability companies, and partnerships.

Theoretically, before any profits are paid to shareholders, a C corporation must pay income tax on the profits at the corporate rate. Any profits that are distributed to shareholders via dividends are then taxed again in the hands of the shareholders at their individual income tax rate. This amounts to double taxation, with the same profits taxed at both the corporate and personal level—not a good thing.

In the real world, however, small C corporations can easily avoid paying income taxes. All of a small C corporation's earnings typically are paid out to its employees as wages, bonuses, and fringe benefits. These are all deductible business expenses. After everyone is paid for their labor, there is usually nothing left for the small business corporation to owe tax upon.

EXAMPLE: Ned's C corporation, Men's Den, Inc., earns \$70,000 one year. But after the corporation pays Ned \$50,000 as a salary, provides him with \$10,000 in tax-free fringe benefits, including retirement plan contributions, and gives him a year-end bonus of \$10,000, the corporation has no taxable net profit. As a result, it owes no federal corporate income tax. Ned, however, pays personal income taxes on \$60,000 of earned income. Ned's fringe benefits of \$10,000 aren't taxable. (Note that the corporation may still be subject to state income taxes.)

If any corporate income is not distributed it may be tied up in inventory or retained to fund future growth. It is taxed, but at corporate tax rates that are, for most small business folks, lower than their personal income tax rates.

EXAMPLE: Instead of giving Ned a year-end bonus of \$10,000, Men's Den, Inc., retains it all for future expansion. This \$10,000 is subject to federal corporate income tax at 15%, resulting in a \$1,500 tax bill to Men's Den. Ned pays taxes on \$50,000 of earned income at his individual income tax rate.

Double taxation of a C corporation's profits will occur if it pays dividends. For instance, if Sonya and Stella are just investors in a corporation and don't work for it, they can't take salaries and fringe benefits. The only way for investors to share in profits is by receiving dividends. However, dividends are not deductible corporate expenses like wages. Dividends are distributed only after corporate income taxes are calculated (taxed once). Next, the dividends are taxed (again) to the shareholders who receive them. (See "Taking Money Out of a C Corporation," below, for a discussion of dividends.)

EXAMPLE: Ned's sisters, Sonya and Stella, each invest \$100,000 in Men's Den, Inc., in return for 100 shares of stock each. Sonya is a salesperson for the business and receives a yearly salary of \$50,000; Stella doesn't work and plays a lot of golf. After paying all wages and operating expenses, Men's Den, Inc., has \$30,000 in profits. Its directors decide to pay out \$30,000 as dividends to the sisters. First, the corporation must pay income tax of \$4,500 (15% corporation tax rate $\times$ \$30,000), leaving \$25,500 for the dividends. Sally and Shirley are each taxed on \$12,750 in dividends on their individual tax returns, along with any other income.



TIP

Avoid dividend double taxation by paying consulting fees. One tax-wise way to compensate shareholders is to style corporate payments as tax

deductible consulting fees, not dividends. However, the shareholder must actually offer business advice, otherwise the IRS could recharacterize the payments as dividends. The shareholder/consultant must pay Social Security and Medicare (FICA) and income taxes on the compensation.

Corporate Operating Losses

Just as C corporation profits belong to the business and not the shareholders, so do losses. Never forget that the corporation is a separate tax entity from its shareholders.

Individual shareholders can't claim annual operating losses of a C corporation business. However, losses on the corporation's books in one year can be offset against future or past years' corporate profits.

EXAMPLE: Men's Den, Inc., loses \$20,000. Ned, who owns 100% of the corporation's stock, received no compensation for his year's work. The corporation's loss provides no tax benefit to Ned when he files his individual tax return. The business operating loss can be used to offset any corporate profits in past or future years, with some restrictions.

Tax Reporting for C Corporations

Almost 2.5 million C corporation tax returns are filed every year. C corporations must file annual federal tax returns, IRS Form 1120, *U.S. Corporation Income Tax Return* (a sample is below). Filing is required regardless of whether or not the corporation has any income. The due date is the 15th day of the third month after the close of the corporation's tax year. If the corporation uses a calendar year, its tax return is due every March 15. (See Chapter 4.)

A corporation can get a six-month extension to file its tax return. For example, September 15

for a calendar-year reporting corporation. If any corporate tax is owed, it must be paid along with the extension (Form 7004) to avoid penalty and interest charges.



CAUTION

Get professional help with C corporation tax returns. They are very tricky and should always be professionally prepared. It's very difficult for anyone other than a pro to do them correctly.

Most states require their resident corporations to file state corporation tax forms each year. The rules and deadlines differ from the federal corporation rules.

Corporation estimated tax payments. If the corporation expects to owe taxes, it must make periodic estimated tax payments during the year, similar to self-employed individuals.

State corporation taxes. States require annual corporate tax filings as well, on separate state corporate tax return forms. Most states require that a minimum corporate franchise tax (typically \$50 to \$800) be paid each year to maintain the corporate status.

Tax on Retained Earnings

Typically, small corporations don't owe income taxes because all profits are paid out as tax-deductible salaries and fringe benefits. But often an enterprise needs money to expand or build up an inventory. This can be done, but at a tax price.

C corporation profits kept in the business are taxed at an initial tax rate of 15%. This rate is usually lower than the individual tax rates of its owners/shareholders. (IRC § 11.)

Retaining earnings at a lower tax cost is an advantage that growing small C corporations have over other entities. However, there are limits on the amount of earnings that a corporation can retain. (See "Accumulated Earnings Tax," below.)

Federal Corporate Tax Rates

Net Income	Total	Tax Rate
First \$50,000	\$50,000	15%
Next \$25,000	\$75,000	25%
Next \$25,000	\$100,000	34%
Next \$235,000	\$335,000	39%
Everything else	\$335,001 +	34%–38%

Note: Most states also impose corporate income taxes.

EXAMPLE: Henry's engine-rebuilding corporation, Top Value Motors, Inc., plans to expand. To do so, it retains \$100,000 of net profit in the business bank account. Top Value owes corporate income taxes on the profit as follows:

$\$50,000 \times 15\%$	=	\$ 7,500
$\$25,000 \times 25\%$	=	6,250
$\$25,000 \times 34\%$	=	<u>8,500</u>
Total tax		<u>\$22,250</u>

This is a blended tax rate of 22.25%.

By contrast, if Top Value paid Henry this \$100,000, depending on his tax bracket, as much as \$35,000 could be added to his federal income tax bill, plus Social Security and Medicare taxes, and maybe state income taxes too!

Income Splitting. Disbursing some corporate profits to shareholders and keeping the rest in the business amounts to income splitting. For instance, by keeping up to \$75,000 in the corporation and paying the rest of the profits as wages and bonuses, most corporations can save taxes.

Once a corporation reaches the \$100,000 profit level (after paying salaries and benefits), retaining earnings makes less tax sense. This is because corporate profits between \$100,001 and \$335,000 are hit with a 5% tax surcharge, effectively eliminating the benefits of the initial lower corporate tax rates.

Sample Form 1120—page 1

Form 1120 Department of the Treasury Internal Revenue Service	U.S. Corporation Income Tax Return For calendar year 2010 or tax year beginning _____, 2010, ending _____, 20____ ▶ See separate instructions.	OMB No. 1545-0123 20XX			
A Check if: 1a Consolidated return (attach Form 851) ☐ b Life/nonlife consolidated return ☐ 2 Personal holding co. (attach Sch. PH) ☐ 3 Personal service corp. (see instructions) ☐ 4 Schedule M-3 attached ☐					
Print or type	Name Roses in Bloom, Inc. Number, street, and room or suite no. If a P.O. box, see instructions. 876 Yellow Brick Road City or town, state, and ZIP code American Beauty, Idaho 83860	B Employer identification number 12-345678 C Date incorporated 7-1-82 D Total assets (see instructions) \$ 65,987			
E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change					
Income	1a Gross receipts or sales <u>248,000</u> b Less returns and allowances <u>7,500</u> c Bal ▶ 2 Cost of goods sold (Schedule A, line 8) _____ 3 Gross profit. Subtract line 2 from line 1c _____ 4 Dividends (Schedule C, line 19) _____ 5 Interest _____ 6 Gross rents _____ 7 Gross royalties _____ 8 Capital gain net income (attach Schedule D (Form 1120)) _____ 9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797) _____ 10 Other income (see instructions—attach schedule) _____ 11 Total income. Add lines 3 through 10. ▶	1c <u>240,500</u> 2 <u>144,000</u> 3 <u>96,500</u> 4 _____ 5 <u>942</u> 6 _____ 7 _____ 8 _____ 9 _____ 10 _____ 11 <u>97,442</u>			
Deductions (See instructions for limitations on deductions.)	12 Compensation of officers (Schedule E, line 4) ▶ 13 Salaries and wages (less employment credits) _____ 14 Repairs and maintenance _____ 15 Bad debts _____ 16 Rents _____ 17 Taxes and licenses _____ 18 Interest _____ 19 Charitable contributions _____ 20 Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562) _____ 21 Depletion _____ 22 Advertising _____ 23 Pension, profit-sharing, etc., plans _____ 24 Employee benefit programs _____ 25 Domestic production activities deduction (attach Form 8903) _____ 26 Other deductions (attach schedule) _____ 27 Total deductions. Add lines 12 through 26. ▶ 28 Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11. 29 Less: a Net operating loss deduction (see instructions) 29a _____ b Special deductions (Schedule C, line 20) 29b _____	12 <u>23,000</u> 13 <u>24,320</u> 14 _____ 15 _____ 16 <u>6,000</u> 17 <u>3,320</u> 18 <u>1,340</u> 19 <u>1,820</u> 20 _____ 21 _____ 22 _____ 23 _____ 24 _____ 25 _____ 26 <u>3,000</u> 27 <u>62,800</u> 28 <u>34,642</u> 29a _____ 29b _____			
Tax, Refundable Credits, and Payments	30 Taxable income. Subtract line 29c from line 28 (see instructions) 30 _____ 31 Total tax (Schedule J, line 10) 31 <u>5,196</u> 32a 2009 overpayment credited to 2010 32a _____ b 2010 estimated tax payments 32b <u>6,000</u> c 2010 refund applied for on Form 4466 32c () d Bal ▶ 32d <u>6,000</u> e Tax deposited with Form 7004 32e _____ f Credits: (1) Form 2439 (2) Form 4136 32f _____ g Refundable credits from Form 3800, line 19c, and Form 8827, line 8c 32g _____ 33 Estimated tax penalty (see instructions). Check if Form 2220 is attached ☐ 33 _____ 34 Amount owed. If line 32h is smaller than the total of lines 31 and 33, enter amount owed 34 _____ 35 Overpayment. If line 32h is larger than the total of lines 31 and 33, enter amount overpaid 35 <u>804</u> 36 Enter amount from line 35 you want: Credited to 2011 estimated tax ▶ <u>804</u> Refunded ▶ 36 _____	30 <u>34,642</u> 31 <u>5,196</u> 32a _____ 32b <u>6,000</u> 32c () 32d <u>6,000</u> 32e _____ 32f _____ 32g _____ 32h <u>6,000</u> 33 _____ 34 _____ 35 <u>804</u> 36 _____			
Sign Here	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.				
Print/Type preparer's name	George Rose	Date	2-15-11	Title	President
Paid Preparer Use Only	Firm's name ▶ Firm's address ▶	Check ☐ if self-employed	PTIN	Firm's EIN ▶	Phone no.

Sample Form 1120—page 2

Form 1120 (2010)

Page **2****Schedule A** Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1	2,530
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	Total. Add lines 1 through 5	6	146,010
7	Inventory at end of year	7	2,010
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	144,000

9a Check all methods used for valuing closing inventory:

(i) ☒ Cost

(ii) ☐ Lower of cost or market

(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d** _____

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

Schedule C Dividends and Special Deductions (see instructions)

	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1 Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2 Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3 Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4 Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5 Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6 Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7 Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8 Dividends from wholly owned foreign subsidiaries		100	
9 Total. Add lines 1 through 8. See instructions for limitation			
10 Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11 Dividends from affiliated group members		100	
12 Dividends from certain FSCs		100	
13 Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14 Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15 Foreign dividend gross-up			
16 IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17 Other dividends			
18 Deduction for dividends paid on certain preferred stock of public utilities			
19 Total dividends. Add lines 1 through 17. Enter here and on page 1, line 4			
20 Total special deductions. Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b			

Schedule E Compensation of Officers (see instructions for page 1, line 12)

Note: Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) are \$500,000 or more.

(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned		(f) Amount of compensation
			(d) Common	(e) Preferred	
1 George Rose	987-65-4321	100 %	100 %	%	23,000
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	23,000
2 Total compensation of officers					23,000
3 Compensation of officers claimed on Schedule A and elsewhere on return					23,000
4 Subtract line 3 from line 2. Enter the result here and on page 1, line 12					

Form **1120** (2010)

Sample Form 1120—page 3

Form 1120 (2010)

Page **3****Schedule J Tax Computation** (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120))	☐		
2	Income tax. Check if a qualified personal service corporation (see instructions)	☐	2	5,196
3	Alternative minimum tax (attach Form 4626)		3	
4	Add lines 2 and 3		4	5,196
5a	Foreign tax credit (attach Form 1118)		5a	
b	Credit from Form 8834, line 29		5b	
c	General business credit (attach Form 3800)		5c	
d	Credit for prior year minimum tax (attach Form 8827)		5d	
e	Bond credits from Form 8912		5e	
6	Total credits. Add lines 5a through 5e		6	
7	Subtract line 6 from line 4		7	5,196
8	Personal holding company tax (attach Schedule PH (Form 1120))		8	
9	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Form 8902 ☐ Other (attach schedule)		9	
10	Total tax. Add lines 7 through 9. Enter here and on page 1, line 31		10	5,196

Schedule K Other Information (see instructions)

1	Check accounting method: a ☐ Cash b ☒ Accrual c ☐ Other (specify) ▶	Yes	No
2	See the instructions and enter the:		
a	Business activity code no. ▶ 5995		
b	Business activity ▶ Flower shop		
c	Product or service ▶ Flowers		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidary controlled group? If "Yes," enter name and EIN of the parent corporation ▶		X
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)	X	
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851, Affiliations Schedule? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).		X

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

Form **1120** (2010)

Sample Form 1120—page 4

Form 1120 (2010)

Page 4

Schedule K *Continued*

				Yes	No
b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).					X
(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital		
6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) If "Yes," file Form 5452 , Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.					X
7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of (a) the total voting power of all classes of the corporation's stock entitled to vote or (b) the total value of all classes of the corporation's stock? For rules of attribution, see section 318. If "Yes," enter: (i) Percentage owned ▶ _____ and (ii) Owner's country ▶ _____ (c) The corporation may have to file Form 5472 , Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶ _____					X
8 Check this box if the corporation issued publicly offered debt instruments with original issue discount ☐ If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.					
9 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ \$ _____					
10 Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ _____					
11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.					
12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ \$ _____					
13 Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year and its total assets at the end of the tax year less than \$250,000? If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ \$ <u>248,000</u>				X	
14 Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)? If "Yes," complete and attach Schedule UTP.					X

Form **1120** (2010)

Sample Form 1120—page 5

Form 1120 (2010)

Page **5**

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
Assets		(a)	(b)	(c)	(d)
1	Cash				
2a	Trade notes and accounts receivable	20,540		18,498	
b	Less allowance for bad debts	()	20,540	()	18,498
3	Inventories				
4	U.S. government obligations		2,530		2,010
5	Tax-exempt securities (see instructions)		13,807		45,479
6	Other current assets (attach schedule)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()		()	
11a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()		()	
14	Other assets (attach schedule)				
15	Total assets		36,877		65,987
Liabilities and Shareholders' Equity					
16	Accounts payable		6,415		6,079
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach schedule)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach schedule)				
22	Capital stock: a Preferred stock				
	b Common stock	20,000	20,000	20,000	20,000
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach schedule)				
25	Retained earnings—Unappropriated		10,462		39,908
26	Adjustments to shareholders' equity (attach schedule)				
27	Less cost of treasury stock		()		()
28	Total liabilities and shareholders' equity		36,877		65,987

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return**Note:** Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books	29,446	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	5,196		Tax-exempt interest \$	
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):				
5	Expenses recorded on books this year not deducted on this return (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$	
b	Charitable contributions \$		b	Charitable contributions \$	
c	Travel and entertainment \$				
6	Add lines 1 through 5		9	Add lines 7 and 8	
			10	Income (page 1, line 28)—line 6 less line 9	34,642

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year	10,462	5	Distributions: a Cash	
2	Net income (loss) per books	29,446		b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	
4	Add lines 1, 2, and 3		8	Balance at end of year (line 4 less line 7)	39,908

Form **1120** (2010)

EXAMPLE: Top Value Motors, Inc., retains a \$200,000 net profit after paying salaries and fringe benefits. The corporation owes \$61,250 tax to the IRS (\$22,250 on the first \$100,000 and \$39,000 on the second \$100,000). This is an average tax rate of about 31%.

Less Common Taxes

A C corporation faces three other potential federal taxes that other business entities don't have to worry about:

- the accumulated earnings tax
- the personal holding company tax, and
- the corporate alternative minimum tax.

All of these are discussed in “Tax Pitfalls of C Corporations,” below.



SEE AN EXPERT

Get help with corporate tax matters. This chapter covers only the basics—not the details—of corporate tax rules. Because the learning curve to master corporate tax intricacies is steep, you should always involve a tax pro.

Tax Benefits of C Corporations

C corporations offer the greatest tax planning benefits, but not until the venture is very profitable. Let's look at a few tax opportunities.

Income Splitting

A C corporation may engage in income splitting—that is, dividing income between the corporation and the shareholders in a way that lowers overall taxes. This benefits shareholders in the higher tax brackets. (See “Tax on Retained Earnings,” above.)

Another Incorporation Advantage: Fewer Audits

Incorporating a small business lowers your audit odds. Corporations reporting under \$100,000 of gross receipts per year are audited at one-third the rate of unincorporated businesses with the same income. Only when a business brings in over \$1 million per year do the audit odds turn against corporations.

More Fringe Benefits

A C corporation enjoys the greatest variety of tax-favored fringe benefits of all business entities. New ventures typically can't afford fringes, so this is not an advantage for start-ups. But once your business's annual net income exceeds \$100,000, consider a C corporation.

A fringe benefit is any tax-advantaged thing of value, like health insurance, allowed a business owner or employee. A fringe benefit is either partially or totally tax-free to the recipient and is usually deductible for the business.

Two big C corporation fringe benefits are retirement and medical reimbursement plans. While any business owner can establish a retirement plan, C corporations offer greater contribution limits and flexibility.

With a medical reimbursement plan, the C corporation reimburses the employee for any medical expenses not covered by insurance and then deducts these amounts as business expenses. The tax savings are usually greater than taking the same medical expense deductions on the shareholders'/employees' individual income tax returns.



CAUTION

Benefits must be offered to all employees. The principal drawback of corporate fringe benefits is

that they must be given to most, if not all, employees of the corporation—not just the owner-shareholders. This could be a very expensive proposition for a small business with more than a few employees.

See Chapter 15 and Chapter 16 for more information on fringe benefits and retirement plans.

Corporate Business Losses

While no one enjoys losing money in a venture, it happens. So, let's look for a tax break to cushion the blow. The good news is that there are few restrictions on claiming losses in a C corporation. And the losses may be carried over to future or past corporate tax years for tax benefits.

By contrast, sole proprietors, partners, and limited liability company owners are subject to more restrictive rules for claiming tax benefits from business losses. (See Chapter 5 for more information on claiming business losses.)

Dividends Received From Other Corporations

Another tax break reserved for C corporations is the dividends received deduction. This helps if your C corporation holds stock of another corporation. This rather strange rule says that a C corporation may receive dividends from stock it owns in another unrelated corporation 70% tax-free. In other words, while you as an individual are taxed on 100% of a \$1,000 stock dividend, a C corporation is taxed on only \$300. Not many small corporations claim this tax deduction because not many small corporations own stock in other corporations that pay dividends.

Charitable Contributions

C corporations can deduct charitable contributions and they get a bonus deduction for certain

donations. See IRS Publication 561, *Determining the Value of Donated Property*, for details.

Corporations must get a qualified appraisal of property donated when it's more than \$5,000 in value. While individual shareholders can take charitable deductions, they may get a greater tax benefit if the corporation makes the donation instead. Check with your tax pro and run the numbers both ways.

Limited Liability: A Nontax Reason to Incorporate

Most small business owners incorporate to limit their personal liability for debts of their business—not for tax purposes. The United States is the most “sue-happy” place in the world. If you are in business long enough, you will likely be sued, and if you lose, life as you know it could be over.

Incorporating provides a shield that separates your business assets and liabilities from your personal finances. For instance, a customer who is injured on your premises can sue only your corporation—not you personally. If the judge rules against you, the injured customer can collect only from corporate assets—not your house or personal bank account. Ditto if your business fails and can't pay its creditors. Of course, you lose this protection if you personally guarantee corporate obligations to suppliers, who sometimes require this.

So deciding to incorporate (and whether to be a C or S corporation) involves weighing pros and cons. The *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo), discusses the nontax issues involved in choosing a business entity. Another helpful resource is *LLC or Corporation? How to Choose the Right Form for Your Business*, by Anthony Mancuso (Nolo). So, do your homework and then sit down with a tax pro to confirm whether your choice makes good tax sense.

Incorporating Your Business

A C corporation isn't cheap to form or run. Don't make this decision without checking with both a legal and a tax adviser.

Remember, a corporation is a separate tax entity from its owners. Normally when two taxpayers transfer assets between themselves, there are potential tax issues. However, you can incorporate without tax consequences if certain rules are followed. (IRC § 351.) We discuss some of these start-up issues below.

Putting Cash Into a New Corporation

Typically, people put money into a corporate bank account in return for shares of stock. Accountants call this capitalizing the business.

Whether buying shares of Microsoft or starting your own Minisoft corporation, there are no tax consequences of acquiring stock. You are making an equity investment. The taxes come later, if and when you get rid of your stock.

EXAMPLE: Marty incorporates her biotech newsletter business and puts \$10,000 into its bank account. In return, Marty, Inc., issues Marty 1,000 shares of stock. This is tax-treated as an equity investment by Marty, in Marty, Inc., with no tax consequences. Later, when Marty sells her shares or dissolves Marty, Inc., and receives the money or assets, she will be taxed only if she has a gain—that is, if she receives more than her \$10,000 tax basis in the stock. Her gain will be taxed at favorable capital gains rates if she has held her stock at least one year.



CAUTION

Always adequately fund your corporation.
Make sure there is enough money in your corporation

to meet its expenses and pay its debts. Otherwise, the IRS, a court, or a creditor might say the corporation is undercapitalized and hold you personally liable for corporate debts.

While there is no minimum investment required for federal tax purposes, there might be under your state's law. Most states require corporations to have sufficient cash or other assets to show that they are not empty shells. This is called adequate capitalization.

Lending Money to Your New Corporation

Incorporators are often tempted to lend money to their new corporation rather than purchase stock. The first money taken out of the business would then be a repayment of the shareholder's loan. In effect, the shareholders would receive a tax-free return of their investment. Sounds great, right?

Sorry—the tax code frowns on shareholder loans (debt) for a corporate start-up. There must be a cash or property investment (equity) for stock. A shareholder cannot take back any corporate IOUs (debts) for his or her initial contributions to a start-up. (IRC § 351.)

Only when a corporation is up and running may a shareholder loan be okay.

Putting Assets Into a New Corporation

It's okay to transfer things other than cash—such as a building, vehicle, or patent you own—to your corporation in exchange for its stock. It's worth paying attention to how you do the transfer though so you take advantage of an important tax break that's available for these types of transfers.

Section 351 transfers

Transferring an asset to a corporation for stock is potentially taxable. Thankfully, a special tax code

provision, Section 351, lets you avoid paying any taxes at the time the transfer is made.

With Section 351, there's no tax until you sell the stock received in exchange for the assets at a profit (or the corporation is dissolved and you receive money or assets worth more than your initial investment).

EXAMPLE: Mario transfers his warehouse (which he has owned for ten years and which has a tax basis of \$50,000) to Mario Brothers, Inc., in exchange for stock. The warehouse has a fair market value of \$100,000.

Without Section 351, the tax code would treat this transfer as if Mario sold his warehouse to Mario Brothers, Inc. So Mario would have a taxable gain of \$50,000—the difference between his \$50,000 basis and the \$100,000 market value. Under Section 351, Mario doesn't need to pay any taxes on the exchange. Instead, he'll owe taxes only on any profit he receives if he sells the stock for more than \$100,000.

How to meet Section 351 conditions

When transferring assets to your corporation, four conditions must be met to qualify as a Section 351 transfer:

1. **The corporation must receive real estate or personal property in exchange for stock.** Real estate and equipment are the most common types of assets, but you can also transfer just about anything of value.
2. **Shareholders must receive only stock in exchange for the property.** Transferors can't take back cash, bonds, corporate promissory notes, or more complicated instruments like stock warrants or stock options. And each shareholder must receive stock in direct proportion to the fair market value of the property transferred.

EXAMPLE: Joe transfers \$20,000 fair market value of equipment and Jill transfers \$20,000 worth of real estate to Joe & Jill, Inc. Each must get an equal number of shares of stock in return.



CAUTION

If a transferor gets anything but stock, its value is taxable income to that shareholder. For instance, if, in addition to stock, Joe receives a \$10,000 promissory note from Joe & Jill, Inc., \$10,000 of income is taxable to him.

3. **The shareholders who transfer assets must own 80% of the corporation.** Taken as a group, shareholders who transfer property for stock must own at least 80% of the new corporation's shares after the transfer. Since the stock of most small business corporations is held by only a handful of investors, this usually is not a problem.

EXAMPLE: Paul, Ringo, and John want to incorporate and use Section 351. Paul and Ringo transfer \$170,000 in biotech research equipment, previously used by their P & R partnership, in return for 75% of the shares of Bio Research, Inc. John, who is retired and does not intend to work in the business, is internationally known in this field; the corporation gives him 25% of the shares outright on condition that it can advertise his name as a shareholder. This transaction fails Section 351 rules because, after the transfer, Paul and Ringo own less than 80% of the stock.

4. **No stock may be given in exchange for future services.** This condition of Section 351 causes the most problems. Any shareholders who get stock for their promise of service

will owe income tax on the value of the stock received.

EXAMPLE: Wanda and Perry form Galaxy Inc. to help businesses advertise on the Internet. Perry contributes \$100,000. Wanda, who is broke, promises to apply her skill with online networks. They each receive 250 shares of Galaxy Inc. Wanda's stock doesn't qualify under Section 351, so she is taxed on \$50,000, the value of her half of the corporation's stock. Perry is not taxed, because he is qualified under Section 351. Given this result, Wanda may not want to become a stockholder of Galaxy Inc.

Valuing stock in a Section 351 transfer

Stock received for assets (other than cash) has the same tax basis as the asset. In tax lingo, this is "substituted basis." So, the tax basis of your stock equals your basis in the property you exchanged for it—not the property's fair market value. For tax purposes, you have the same investment in the stock as you did in the asset transferred for it.

EXAMPLE: When he forms Jones, Inc., Jason transfers a building he owns for stock. Jason's tax basis in the building, valued at \$110,000, was \$75,000, so his basis in his Jones, Inc., stock is \$75,000. The actual fair market value of the building (\$110,000) is irrelevant to Jason's basis in his stock.

If you have property that has gone down in value, you won't want to do a Section 351 transfer with that property. As a shareholder, you can't claim a taxable loss when transferring property to your own corporation under Section 351. That

means you lose the potential tax benefit of a tax loss for that property. In addition, the IRS related party rules prohibit shareholders with more than a 50% interest in a corporation from claiming any tax losses on transactions between the shareholder and the corporation. If you have property that has gone down in value, see a tax pro before transferring the property to a corporation.

Section 351 filing by corporations and shareholders

A corporation and each shareholder must report all Section 351 transfers. A 351 statement listing all property transferred must be attached to the tax returns of each shareholder and to the first corporation return. There is no IRS preprinted form for this, so get help from a tax pro here. (Reg. 1.351-3.)

Note Section 351 transfers from shareholders in the corporate minutes book. Shareholders should also keep records of assets transferred—for as long as they own their shares, and for at least three years after they dispose of them (just in case the IRS comes calling).



SEE AN EXPERT

Transfers to a corporation may still be taxed under state and local laws. Section 351 is a federal tax rule. State and local laws may treat transfers of shareholder assets as taxable sales to the corporation. For example, a retail clothier transferring his inventory of men's suits to his new corporation may be hit with his state's sales or inventory tax. There may be other unexpected state tax issues from a Section 351 transfer. For instance, real estate transferred to a corporation may trigger a property tax reassessment. In California, it usually means a property tax hike. You might be better off leasing your real estate to your corporation. See a tax pro or contact state and local tax agencies before making any transfers.

Shareholder Loans to an Established Corporation

Once a corporation is established and profitable, a shareholder can make loans to it to fund its operations or for expansion. A loan beats making a further capital contribution, because the shareholder can take a loan repayment without any tax consequences. Otherwise, money taken out of the corporation by a shareholder is taxable income, either as compensation for services or as a dividend.

A shareholder loan must meet legal formalities and be a commercially reasonable transaction to pass potential IRS audit scrutiny. The IRS wants to make sure that the shareholder loan is not really a capital investment in disguise. If the loan terms are not realistic (such as a zero percent interest rate and no fixed repayment date), the IRS can reclassify the loan repayments as taxable dividend payments to the shareholder.

There is a limit to the amount of funds shareholders can lend to their corporation. It is determined by the corporation's debt-to-equity ratio. Put simply, a corporation can't have too much debt relative to the investment of the shareholders in the business; otherwise the corporation is termed thin, or under-

capitalized. An acceptable debt-to-equity ratio is usually 3:1 or lower. Anything beyond 3:1 could raise the issue of an undercapitalized corporation in the eyes of the IRS.

EXAMPLE: Arturo puts \$30,000 in Arturo's Tile Corporation (ATC) to start the business. Later, ATC borrows \$90,000 from Arturo to fund a business expansion. ATC's debt (\$90,000) to shareholder equity (\$30,000) ratio is 3:1, which is usually an acceptable ratio to an IRS auditor, so the loan should be fine as long as its interest and repayment terms are commercially reasonable.

IRS auditors will challenge a shareholder loan that is not well documented. There should be promissory notes and corporate resolutions approving the loan recorded in the minutes of a board meeting. The terms of the loan must be met—for example, the interest and principal should be repaid when due. For promissory notes and resolution forms, see *The Corporate Records Handbook* or *Corporate Loans: Create Promissory Notes and Resolutions* (an eGuide), both by Anthony Mancuso (Nolo).

The Importance of Issuing Section 1244 Stock

A small business C corporation should always issue Section 1244 stock. (S corporations don't qualify for Section 1244—see Chapter 9.) This enables shareholders to get better tax treatment if they lose money on the disposition of their C corporation stock. (See Chapter 5 for an explanation of how this works.)

There is no downside, and it is easy to qualify for Section 1244 treatment. Here are the rules—most of which should not be a problem:

- Section 1244 corporate shares may be issued only in return for money or property. You

can't exchange stocks or bonds from another corporation, or contribute services, in return for Section 1244 stock. And Section 1244 stock can't be issued in return for canceling a prior debt to the shareholder.

- Investors must be individuals—not other business entities, such as partnerships, LLCs, or other corporations.
- No more than 50% of the corporation's gross receipts during the preceding five years (or the life of the corporation) can be passive income. Passive income includes royalties, dividends, interest, rents, annuities, or gains from securities or stock. Section 1244

corporation losses must be from active business operations, not investments.

- The total money or property received by the corporation for Section 1244 stock cannot exceed \$1 million.
- The corporation must be a domestic (U.S.) company.
- The shareholder must be the original purchaser of the stock.



TIP

Authorize more shares than you'll sell.

Folks seldom risk putting big bucks into a start-up venture. But an investor can't claim Section 1244 treatment for any contributions made after the initial shares were issued. You can solve this dilemma by treating any money later contributed as payment for Section 1244 stock that was authorized but not issued. The example below shows how to do this.

EXAMPLE: HairCo, a new corporation, authorizes 1,000 shares of Section 1244 stock to be issued to Morey, who promises to pay \$100 per share. When HairCo is formed, Morey pays \$40,000 for 400 shares. The next year Morey pays \$60,000 for 600 authorized shares, a total of \$100,000. All of Morey's stock is Section 1244 stock.

The Section 1244 Corporate Resolution

Always adopt a written corporate resolution at the time the corporation first issues stock, stating that the shares are Section 1244 stock. You might get by an IRS audit without a written resolution if you meet the above conditions, but why take the risk? Even a postdated resolution (made after the stock was issued) will probably pass IRS muster.

Neither the corporation nor the shareholders have to file the resolution with the IRS. Just keep it in your corporate records book in case the IRS decides to question the investment loss during an

audit. A sample Section 1244 resolution is shown below.

Sample Section 1244 Resolution

The board considered the advisability of qualifying the stock of this corporation as IRC § 1244 stock as defined in the Internal Revenue Code, and of organizing and managing the corporation so that it is a small business corporation as defined in that section. Upon motion duly made and seconded, it was unanimously

RESOLVED, that the proper officers of the corporation are, subject to the requirements of federal law and the law of this state, authorized to sell and issue shares of stock in return for the receipt of the aggregate amount of money and other property, as a contribution to capital and paid-in surplus, which does not exceed \$1,000,000.

RESOLVED FURTHER, that the sale and issuance of shares of stock shall be conducted in compliance with IRC § 1244 so that the corporation and its shareholders may obtain the benefits of that section.

RESOLVED FURTHER, that the proper officers of the corporation are directed to maintain such records as are necessary pursuant to IRC § 1244 so that any shareholder who experiences a loss on the transfer of shares of stock of the corporation may determine whether he or she qualifies for ordinary loss deduction treatment on his or her individual income tax return.

Date

Secretary

Claiming a Section 1244 Loss

A Section 1244 stock investment loss is claimed on IRS Form 4797. This form is filed with each shareholder's individual income tax return after the year of the loss. The form is on the IRS's website at

www.irs.gov. See “Incorporated Business Losses,” in Chapter 5 for more information.

Taking Money Out of a C Corporation

A C corporation opens up several tax opportunities for shareholders/owners in taking money out of their business. Because a corporation is a separate legal and tax entity from its owners, you and your corporation may engage in beneficial financial dealings, such as loans, between each other.



CAUTION

Pay attention to corporate formalities; the IRS does. Always prepare corporate minutes or resolutions (records) of corporate financial transactions—loans, compensation of officers, and so forth. IRS auditors often inspect corporate records. If you haven’t kept up your corporate paperwork, an auditor can say you didn’t really have an incorporated business. Then, tax benefits can be disallowed because corporate records books are not up-to-date or state filings for the corporation were not made.

Compensation for Services

If you work in your incorporated business, you are not self-employed. You are an employee of your corporation, just like the secretary and janitor.



TIP

Small corporations may benefit from putting the owner/shareholder’s spouse and kids on the payroll. Spreading family business income over lower tax brackets is legal as long as everyone does real work and isn’t overpaid. (See Chapter 13.)

In theory, the tax law (rather vaguely) limits the wages you can receive from your C corporation—salaries and bonuses paid to shareholder-employees must be reasonable. (IRC § 162.) Corporations paying unreasonable compensation

for personal services can have this wage expense disallowed or reduced during an IRS audit.

An IRS auditor can also assess a 25% penalty on certain excessive salaries. This penalty applies to officers, directors, and family members of closely held corporations. Also, penalties can be applied if corporate assets are transferred at large discounts instead of cash. (Again, this is not usually a concern for small business corporations.)

Here’s one real-life case where a million-dollar annual salary was okay: The principal stockholder was the CEO, who designed products sold by the company. The tax court found that the products he designed were responsible for increased sales, so, in effect, he performed more than one job. The \$1 million corporate compensation was not unreasonable under these circumstances. (*PMT Inc. v. CIR*, TC Memo 1996-303.)



TIP

Prepare for an IRS audit challenge for unreasonable compensation. Assuming you do significant work for your corporation, draw up an employment contract stating your salary and duties. This shows that your pay was a well-thought-out business decision.

Keep your stated salary fairly consistent from year to year—even if the corporation does not always have enough funds to pay it. Otherwise, if your salary is tied to profits, it looks more like a corporate dividend on your investment, and not wages. If the corporation has a down year and can’t pay your scheduled salary, get a promissory note from the corporation. Then take funds when they’re available in future years as payment on the note. Document shareholder compensation decisions in the minutes of the corporation.

Dividends

A C corporation may pay dividends to shareholders if it has enough current and retained earnings to also pay its debts. But, this may not make tax sense because the corporation is taxed

on its profits before the dividend is paid, and the recipient shareholder is taxed again. When a small corporation pays dividends, it's usually done for shareholders who don't work in the business and aren't paid salaries.

Lower Tax on Dividends

For individuals, qualified corporate dividends are taxed at 5% to 15% instead of at ordinary income tax rates (which range up to 35%). For details, see Publication 550, *Investment Income and Expenses*, or talk to a tax pro to see if your corporation's dividends qualify for this tax break.

Directors' fees. A C corporation can pay fees to directors. These payments are taxable to the directors, and deductible by the corporation. This tax savings is a potential income splitting opportunity. See Chapter 13.

Loans to Shareholders

A profitable C corporation may lend money to its shareholders. A loan from your C corporation isn't taxable income to you and doesn't have tax consequences to the corporation. Interest paid by the borrower on the loan is income to the corporation, of course.

Shareholder loans must be bona fide. The borrowers must promise in writing to repay the loan at a specific date, and the loan should be secured by pledging assets, which will be forfeited if the loan is not repaid.



TIP

Corporations can make loans to shareholders of less than \$10,000—interest-free. Larger loans must carry a commercially reasonable rate of interest—at least the minimum legal interest rate. (See “Checklist for Loans to Shareholders,” below.)

Checklist for Loans to Shareholders

A loan to a shareholder should look like a bank loan, to withstand an auditor's challenge. Plus, the parties must abide by its terms. The corporation shouldn't give a shareholder any breaks—such as forgiving interest on the loan—that a bank wouldn't give. Here are the specifics:

- The corporate records should reflect all loans.
- The shareholder should sign a promissory note for a specific amount.
- The note should obligate the shareholder to repay the loan unconditionally on a specific date or in regular installments.
- The corporation should charge at least the applicable federal rate (AFR). The Treasury Department sets this rate once a month; call the IRS or check the IRS website at www.irs.gov for the current AFR rate. If a corporation doesn't charge at least this rate, an IRS auditor can attack it as a below market loan (IRC § 7872) and the borrower will be taxed on the value of the undercharged interest.
- The note should be legally transferable by the corporation to a third party.
- The loan should be secured by collateral such as a bank account, real estate, or other shareholder property.
- The note should stand on equal footing with debts of others to the corporation.
- The note should give the corporation the right to sue and take the collateral if the shareholder does not repay the loan on time.
- The shareholder should make all interest and principal payments when due.

For promissory notes and resolutions, see *The Corporate Records Handbook* or *Corporate Loans: Create Promissory Notes and Resolutions* (an eGuide), both by Anthony Mancuso (Nolo).

The IRS knows shareholders are tempted to label all withdrawals from their corporation as loans, because loans are not taxable income. So, if a loan doesn't look legitimate, an IRS auditor can rename it and tax it as compensation or a dividend payment.

Leasing Assets to Your Corporation

Leasing things that you own to your corporation is another way to extract cash—without paying taxes on dividends or employment taxes on salaries.

Real estate is most often leased to a corporation by its shareholders, but leasing can also work tax-wise for things like equipment or machinery.

Leasing to your corporation can produce a paper loss for you, the shareholder, which you may be able to offset against your other income. Typically, the loss comes from your depreciation deduction on the leased asset. It can also come when cash expenses exceed cash income. Either way, the loss may offset, or shelter, any other income on your tax return.

EXAMPLE: On January 1, Bart buys a building for \$100,000. He immediately leases it to his C corporation, Homer, Inc., at the market rate of \$12,000 per year. Since the building is worth \$80,000 (the lot is worth \$20,000), Bart is allowed to take depreciation deductions of \$2,051 per year. Bart incurs annual expenses for real estate taxes, maintenance, and mortgage interest on the building totaling \$11,400. After applying the rent payments from Homer, Inc., Bart reports a loss of \$1,451 on his tax return (\$12,000 income – \$11,400 expenses – \$2,051 depreciation = \$1,451 tax loss). **Note:** Passive loss rules for real estate may limit Bart's ability to offset rental losses against other income. They are beyond the scope of this book, however, so check with a tax pro.



TIP

To pass IRS audit muster, a lease between a shareholder and the corporation must be a realistic deal. The lease payment must be close to fair market value. But because rents for similar assets can vary, you can charge your corporation a bit more (or less) than you might get from others. How much depends on several factors. A 25% discrepancy from fair market value is usually defensible—especially if you can back it up with a written opinion from a professional that the rent paid is within the market range.

EXAMPLE: Brenda owns a storefront building and rents it to her incorporated bakery business, Tarts to Go, Inc. The building might rent for \$500 a month on the open market, but its size, amenities, and location are unique, making precise valuation difficult. Brenda is probably safe renting it to Tarts to Go for \$625 a month, but \$2,000 is not likely to fly at an IRS audit.



TIP

Leasing assets limits your liability. A good nontax reason for leasing personal assets to your corporation (rather than having the business own it) is to protect them from corporate liabilities. For instance, suppose your corporation is successfully sued for sexual harassment. The judgment can be collected against the corporation's property, but your leased assets are probably safe. Even if the corporation declares bankruptcy, leased property is not a corporate asset; it still belongs to you, its owner.

Selling Your Corporate Stock

A share of corporate stock—a fractional ownership interest in a business—is an asset. As with any asset, its sale means a gain or loss for shareholders. Here are the rules.

Capital gains

A shareholder's gain on sale of stock held longer than one year is taxed at a reduced capital gains rate. (See Chapter 3.)

EXAMPLE: Robin forms RRR, Inc., and transfers his warehouse to the corporation in exchange for stock. Because of Section 351, the transfer is not taxable. His basis in the warehouse—\$75,000—becomes his basis in his stock.

Two years later, Robin sells his stock to Wanda for \$175,000. Robin has a taxable gain of \$100,000 (\$175,000 minus his basis in his stock of \$75,000). The capital gains tax on Robin's profit is a maximum of 15% (IRC § 1(h)), making his tax liability \$15,000. (Robin's state tax agency will get a cut of the action, too.) Without the capital gains tax rate, Robin's federal tax could have been as high as \$35,000, at a tax rate of 35%.

Lower Capital Gains Tax

The long-term capital gains tax is now a maximum of 15% for gains on sales of corporate stock held more than one year. And folks in the lower 10% or 15% income tax bracket pay only 5% on long-term gains (2011). For more information, see IRS Publication 550, *Investment Income and Expenses*, or talk to a tax pro.

Capital losses

Shareholder losses on the sale of stock face some restrictive tax rules. For instance, unless the corporate stock is qualified under Section 1244, a shareholder's net capital losses can only offset his or her ordinary income up to \$3,000 in any one year. (See "Incorporated Business Losses" in Chapter 5 for a detailed explanation.)

Tax Breaks for Qualified Small Corporation Investors

Investors in qualifying C corporations may get a special tax break if they sell their stock at a gain. A gain on the sale of so-called IRC Section 1202 stock is not taxed if it is held for more than five years (2011).

Which corporations qualify? The rules are complex. For instance, at least 80% of the corporation's assets must be used in the active conduct of the business. This eliminates corporations with significant income from investments. And corporations that sell services (like health or legal), or a mix of goods and services (like hotels or restaurants) don't qualify. See IRC Section 1202 or a tax pro for details.

Tax Pitfalls of C Corporations

When you're a C corporation, you are playing with the big boys. Mind-boggling corporate tax complexities occasionally trap small business owners. One worry—double taxation—has been discussed; here are three others.

Personal Holding Company Tax

There is a special penalty tax for C corporations that earn 60% or more of their income from investments, such as dividends and royalties. Don't worry about this if you're running an active business. Otherwise, ask your tax pro if you are subject to the Personal Holding Company rule.

Accumulated Earnings Tax

An advantage of a C corporation over other business entity forms is its ability to accumulate

earnings (roughly meaning to keep profits in its bank account) to fund growth. These earnings are taxed to the corporation—but often at lower rates than if they are distributed to the shareholders.

If, however, a C corporation keeps too much profit in its coffers, it incurs an accumulated earnings tax of 15%. Smaller C corporations can breathe easy—this tax does not kick in until accumulated earnings exceed \$250,000. (IRC § 535.)

Corporate Alternative Minimum Tax

A corporation using certain tax code provisions to lower its income taxes can be punished. The snag is the corporate alternative minimum tax. (IRC §§ 55–58, Reg. 1.55–1.58.) Because few small business corporations ever have this problem, the explanation here is short.

The tax breaks that cause the corporate alternative minimum tax to come into play are called “tax preference” items. These are out-of-the-ordinary things like income from life insurance or from a corporation spreading its tax liabilities into the future by using the installment method of tax reporting. When the alternative minimum tax is calculated, deductions and credits for these preference items are added back to the corporation’s income, increasing its tax bill.

Dissolving a C Corporation

Generally, a corporation can dissolve if more than 50% of the shareholders vote to do so.

A corporation can also cease to exist involuntarily by operation of law—such as from a deadlock of shareholders or nonpayment of state taxes or fees. Neglecting to keep up with state filings and fees is the most common way small corporations die.

Tax Issues Upon Dissolution

The specter of double taxation arises if a dissolving C corporation distributes assets or money to the shareholders. Or, a sale of the business’s assets may mean the corporation owes tax on gain from the sale and the shareholders owe tax again on the money received for their shares.

If the corporation has ever claimed any tax benefits (such as depreciation) on its assets, the corporation’s basis in these assets may be very low or even zero. Depreciation deductions previously taken are recaptured on dissolution and become taxable. The result may be unexpected taxable gain even when the corporation disposes of assets for minimal amounts.

Dissolving a corporation is a good time to bring in a tax pro.



SEE AN EXPERT

Consider switching to S corporation status on your way out. One way around any double-taxation problems on liquidation may be for a dissolving C corporation to elect S corporation status before it liquidates—but don’t try this without first consulting a tax pro.

Reporting the Dissolution to the IRS

While it is relatively easy to dissolve a corporation, if you stop filing corporate income tax returns, expect to hear from the IRS or your state taxing agency.

File IRS Form 966, *Corporate Dissolution or Liquidation*, when your corporation is terminated. See IRC Section 331 and following sections (for shareholders), IRC Section 336 and following sections (for corporations). Better yet, see a tax pro.

C Corporations in a Nutshell

- A C corporation is the only form of business that pays its own income taxes.
- Most small business folks incorporate to shield their personal assets from business liabilities, not for tax reasons.
- Incorporation of an existing business may be taxable unless the tax rules of Section 351 are followed.
- Shareholders working in their corporation are employees and the business must comply with federal and state payroll tax rules.
- Most small C corporations don't pay income tax because all profits are paid to the shareholders as salaries, bonuses, and fringe benefits.
- Small C corporations can keep some profits in the business (called retained earnings) for funds to expand the business or build its inventory. The profits are taxed, but generally at a lower rate than for shareholders.
- A small business C corporation should always issue stock that complies with Section 1244. This allows faster tax write-offs to shareholders if the business fails.
- C corporations are the most expensive entity to set up, operate, and maintain.
- Ending a C corporation can result in unexpected taxes for both the corporation and its shareholders, and should be done with the help of a tax pro.

Resources

- IRS Publication 334, *Tax Guide for Small Business*. This is an indispensable publication for any small business, including C corporations.
- IRS Publication 542, *Corporations*. This booklet is especially useful if you are preparing and filing corporate tax forms without professional assistance.
- IRS Publication 550, *Investment Income and Expenses*. This explains how to calculate the gain or loss on a sale of corporate stock and how to tax report it.
- IRS Form 1120, *U.S. Corporation Income Tax Return and Instructions*.
- *Incorporate Your Business* (National) and *How to Form Your Own California Corporation*, by Anthony Mancuso (Nolo). These books take you through the incorporation process step by step. The forms are available on CD-ROM.
- *The Corporate Records Handbook*, by Anthony Mancuso (Nolo). This book shows you how to write up minutes of corporate meetings and document corporate decisions and transactions, which are often important to withstand IRS scrutiny.
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This excellent book deals with all of the ramifications of operating as a C corporation.
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinnpcpas.com.

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“Corporations cannot commit treason, nor be outlawed, nor excommunicated, for they have no souls.”

—Sir Edward Coke

Before tackling this chapter, take a look at the previous one on C corporations—all corporations are born as C corporations under the tax code. Becoming an S corporation requires an extra step, called a tax election, with vital tax implications. This chapter explains the tax treatment of S corporations and how to become one.

An Overview of S corporations

C and S corporations (the letters refer to subchapters of the Internal Revenue Code) are distinguished by how their income is reported and taxed.

S corporations pass income through to their shareholders, who pay tax on it according to their individual income tax rates. C corporations are separate tax entities that pay corporate income tax on profits.

Electing S corporation status eliminates the possibility of double taxation on business profits. (C corporations may owe income tax at the corporate level, and then the shareholders are taxed again when the corporate profits are put into their hands.) Because S corporations are pass-through entities, their profits are taxed directly to the shareholders, the business's owners. S corporations pay no federal corporate income tax but must file annual tax returns with the IRS and, in most cases, with their home state as well. Some states impose income taxes on S corporations.

Similarly, since losses pass through too, S corporation shareholders take most business operating losses on their individual returns. (There

are restrictions on loss-taking by shareholders who aren't active in the business; see “How S Corporation Shareholders Are Taxed,” below.) By contrast, C corporation operating losses remain in the corporation, so their shareholders cannot claim them on their individual tax returns.

EXAMPLE: Jeannie Smith works as a loan officer for First Bank, earning \$25,000. She and her husband, Sam, also run a small S corporation business selling computers. The Smiths file tax returns jointly. The computer business loses \$15,000 that year. By using this \$15,000 operating loss to offset Jeannie's \$25,000 salary, the Smiths' total taxable income is reduced to \$10,000. After taking into account their exemptions and personal deductions, the Smiths probably won't owe any income taxes. If this had been a regular C corporation, Sam's business loss of \$15,000 wouldn't have offset Jeannie's \$25,000 earnings on the Smiths' personal tax return.

Although an S corporation business is not a tax-paying entity, it is most definitely a tax-reporting entity. S corporations must file an annual corporation tax return, Form 1120S, showing income and expenses and the resulting profits or losses. In a recent year, 4.5 million S corporation tax returns were filed. That is nearly twice as many as C corporation returns.

In addition, an S corporation must file and pay employment taxes on its employees just like a C corporation. (See Chapter 6 for an explanation of employment taxes.) This means that S corporation shareholder-employees don't pay self-employment taxes.

The shareholders must make quarterly estimated tax payments if they will owe over \$1,000 in federal taxes for income from the corporation (except in unusual situations). See Chapter 7.

Should You Choose S Corporation Status?

Most people incorporate for nontax reasons—usually to shield their personal assets from business obligations and lawsuits. Corporate shareholders, unlike partners and sole proprietors, aren't personally liable for business debts.

The S corporation combines this limited liability with pass-through tax treatment—allowing business income and deductions to flow directly to shareholders. This is the same tax result as with a sole proprietorship, partnership, or LLC.

S corporations offer their shareholders tax benefits from operating losses, common in a business's start-up phase. S corporations (unlike C corporations) allow shareholders active in the business to take operating losses against their other income. Investors who don't work in the business can't take this benefit.

The IRS audit rate is lower for S corporations as compared to solo proprietors. This shouldn't drive your decision about what business entity to choose but it's something to keep in mind.



TIP

Start off as an S corporation. New enterprises often elect S corporation status for the early years and, when profitable, convert to a C corporation. Switching to a C corporation produces fringe benefit tax savings and opens the door for splitting income between the corporation and the shareholders. (See "Income Splitting" in Chapter 8, and Chapter 15.)



RELATED TOPIC

Consider an alternative to S corporations—the limited liability company. If an S corporation sounds good, consider a limited liability company (LLC). An LLC, like an S corporation, provides a pass through of business income and losses to individual owners. LLCs also offer the personal liability shield of corporations, but are simpler to form and operate than S corporations.

Qualifying for S Corporation Status

In all likelihood, you will qualify for S status with the IRS, but check these rules to make sure your small business corporation is eligible:

- The corporation is a U.S. corporation with no more than 100 shareholders. This eliminates public corporations. (A husband and wife are considered one shareholder if they own their stock jointly.)
- All shareholders are individual U.S. citizens or resident aliens, other S corporations, or an electing small business trust.
- The corporation has only one class of stock. There can't be any preferred classes of shares or other types of shares that give special privilege to some shareholders.
- All shareholders consent in writing to S corporation status by signing Form 2553. It must be filed with the IRS within two months and 15 days of the corporation's formation. (See sample Form 2553, below.)

S Corporation Disadvantages

S corporations are great for many small business owners, but they are not for everybody. Here are some potential tax disadvantages to consider.

No retained earnings

A successful corporation often wants to squirrel away cash for future growth. Profits remaining in corporations are called retained earnings.

An S corporation, however, cannot retain earnings without the shareholders' having to pay tax on them. Remember, S corporation profits pass through to the shareholders even if left in the coffers.

A C corporation, on the other hand, can keep some profits in the business in return for paying a relatively small amount of tax at low corporate tax rates.

Sample Form 2553—page 1

Form **2553**

(Rev. December 2007)

Department of the Treasury
Internal Revenue Service**Election by a Small Business Corporation**

(Under section 1362 of the Internal Revenue Code)

- See Parts II and III on page 3 and the separate instructions.
► The corporation can fax this form to the IRS (see separate instructions).

OMB No. 1545-0146

Note. This election to be an S corporation can be accepted only if all the tests are met under **Who May Elect** on page 1 of the instructions; all shareholders have signed the consent statement; an officer has signed below; and the exact name and address of the corporation and other required form information are provided.

Part I Election Information

Type or Print	Name (see instructions) <i>XTC Incorporation</i>	A Employer identification number <i>94-000 0000</i>
	Number, street, and room or suite no. (If a P.O. box, see instructions.) <i>123 Main St.</i>	B Date incorporated <i>1/1/2010</i>
	City or town, state, and ZIP code <i>Anytown, CA 90210</i>	C State of incorporation <i>CA</i>

D Check the applicable box(es) if the corporation, after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) ► / /

Caution. A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:

- (1) ☒ Calendar year
 (2) ☐ Fiscal year ending (month and day) ► _____
 (3) ☐ 52-53-week year ending with reference to the month of December
 (4) ☐ 52-53-week year ending with reference to the month of ► _____

If box (2) or (4) is checked, complete Part II

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under **Who May Elect** in the instructions) ► ☐

H Name and title of officer or legal representative who the IRS may call for more information <i>Jose Smegola, President</i>	I Telephone number of officer or legal representative <i>(555) 555-5555</i>
--	--

If this S corporation election is being filed with Form 1120S, I declare that I had reasonable cause for not filing Form 2553 timely, and if this election is made by an entity eligible to elect to be treated as a corporation, I declare that I also had reasonable cause for not filing an entity classification election timely. See below for my explanation of the reasons the election or elections were not made on time (see instructions).

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Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Francine Schwartzkopf
Signature of officer

Secretary
Title

2/28/11
Date

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 18629R

Form **2553** (Rev. 12-2007)

Sample Form 2553—page 2

Form 2553 (Rev. 12-2007)

Page **2****Part I Election Information** (continued)

J Name and address of each shareholder or former shareholder required to consent to the election. (See the instructions for column K.)	K Shareholders' Consent Statement. Under penalties of perjury, we declare that we consent to the election of the above-named corporation to be an S corporation under section 1362(a) and that we have examined this consent statement, including accompanying schedules and statements, and to the best of our knowledge and belief, it is true, correct, and complete. We understand our consent is binding and may not be withdrawn after the corporation has made a valid election. (Sign and date below.)		L Stock owned or percentage of ownership (see instructions)		M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
	Signature	Date	Number of shares or percentage of ownership	Date(s) acquired		
Jose Smegola 123 Main St. Anytown, CA 90210	<i>Jose Smegola</i>	2/10/11	100	1/1/11	123-45-6789	12/31
Francine Schwartzkopf 666 B. St. Anytown, CA 91111	<i>Francine Schwartzkopf</i>	2/15/11	100	1/1/11	987-65-4321	12/31

Form **2553** (Rev. 12-2007)

EXAMPLE: Sam and Jeannie Smith's incorporated computer retail store earns a \$50,000 profit after paying the Smiths \$200,000 in salary. They keep the \$50,000 profit in the corporation bank account. If the business was a C corporation, it would pay income tax of \$7,500 (\$50,000 at a rate of 15%). By contrast, as an S corporation, the \$50,000 is taxed at the Smiths' personal income tax rate, including their income from all sources. The Smiths' rate might be as high as 35%, meaning an additional income tax bill of \$17,500.

Limited employee fringe benefits

S corporations can't provide the full range of fringe benefits that C corporations can. However, smaller businesses often can't afford many fringes anyway, so this is a big deal only for cash-rich, mature corporations. Once a business has substantial earnings, a C corporation offers tax-saving opportunities over an S corporation. That's the time to discuss things with a tax pro.



RELATED TOPIC

Chapter 15 and Chapter 16 discuss tax-advantaged fringe benefits.

Converting a C corporation

If you convert your existing C corporation to an S corporation, there may be some unpleasant tax consequences. Converting to an S corporation will produce a tax bill if the C corporation:

- had passive income (from investments, not business operations)

- used the last-in-first-out (LIFO) method to report inventory
- had unrealized gains on assets of the C corporation, or
- sold appreciated assets in 2011 that had not been held for at least five years after the conversion.

These are fairly complicated issues. Before converting to an S corporation, see a savvy tax pro.

Tax Reporting for S corporations

An S corporation must file IRS Form 1120S for every year of its existence—whether or not it has any income. For most, the tax year is the calendar year, so the return is due on March 15. If your S corporation uses a different tax year (which they are rarely allowed to do), the return is due on the 15th day of the third month following the close of its tax year. You can get a six-month extension by filing Form 7004, *Application for Automatic Extension of Time to File Corporation Income Tax Return*. File it before the return's original due date.

The first two pages of a filled-in Form 1120S is shown below to give you an idea of the kinds of things that you must report to the IRS. This is not to suggest that you prepare your corporation tax return yourself. To the contrary, corporate returns are the stuff that tax pros were made for. If you want to try, at least use tax software such as *TurboTax for Business*.

State corporation tax reporting. S corporations generally must file state tax returns, too, and a separate tax or franchise fee may be imposed.

Sample Form 1120S—page 1

Form 1120S Department of the Treasury Internal Revenue Service	U.S. Income Tax Return for an S Corporation ▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation. ▶ See separate instructions.	OMB No. 1545-0130 20XX
For calendar year 2010 or tax year beginning _____, 2010, ending _____, 20		
A S election effective date 12-01-99 B Business activity code number (see instructions) 5008 C Check if Sch. M-3 attached ☐	TYPE OR PRINT	Name StratoTech, Inc. Number, street, and room or suite no. If a P.O. box, see instructions. 482 Winston Street City or town, state, and ZIP code Metro City, OH 43705 D Employer identification number 10-4487965 E Date incorporated 3/1/75 F Total assets (see instructions) \$ 771,334
G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☐ No If "Yes," attach Form 2553 if not already filed H Check if: (1) ☒ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination or revocation I Enter the number of shareholders who were shareholders during any part of the tax year ▶ 6		
Caution. Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.		
Income	1a Gross receipts or sales 1,545,700 b Less returns and allowances 21,000 c Bal ▶	1c 1,524,700 2 954,700 3 570,000 4 5 6 570,000
Deductions (see instructions for limitations)	7 Compensation of officers 8 Salaries and wages (less employment credits) 9 Repairs and maintenance 10 Bad debts 11 Rents 12 Taxes and licenses 13 Interest 14 Depreciation not claimed on Schedule A or elsewhere on return (attach Form 4562) 15 Depletion (Do not deduct oil and gas depletion.) 16 Advertising 17 Pension, profit-sharing, etc., plans 18 Employee benefit programs 19 Other deductions (attach statement) 20 Total deductions. Add lines 7 through 19 21 Ordinary business income (loss). Subtract line 20 from line 6	7 170,000 8 138,000 9 800 10 1,600 11 9,200 12 15,000 13 14,200 14 15,200 15 16 8,700 17 18 19 78,300 20 451,000 21 119,000
Tax and Payments	22a Excess net passive income or LIFO recapture tax (see instructions) 22b Tax from Schedule D (Form 1120S) 22c Add lines 22a and 22b (see instructions for additional taxes) 23a 2010 estimated tax payments and 2009 overpayment credited to 2010 23b Tax deposited with Form 7004 23c Credit for federal tax paid on fuels (attach Form 4136) 23d Add lines 23a through 23c 24 Estimated tax penalty (see instructions). Check if Form 2220 is attached 25 Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed 26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid 27 Enter amount from line 26 Credited to 2011 estimated tax ▶ Refunded ▶	22a 22b 22c 23a 23b 23c 23d 24 25 26 27
Sign Here Signature of officer John H. Green Date 3-10-xx Title President	Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No	
Paid Preparer Use Only Print/Type preparer's name Preparer's signature Date Check ☐ if self-employed PTIN Firm's name ▶ Firm's EIN ▶ Firm's address ▶ Phone no.		

Sample Form 1120S—page 2

Form 1120S (2010)

Page **2****Schedule A Cost of Goods Sold** (see instructions)

1	Inventory at beginning of year	1	126,100
2	Purchases	2	1,127,000
3	Cost of labor	3	
4	Additional section 263A costs (attach statement)	4	
5	Other costs (attach statement)	5	
6	Total. Add lines 1 through 5	6	1,253,100
7	Inventory at end of year	7	298,400
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	954,700

9a Check all methods used for valuing closing inventory: (i) ☐ Cost as described in Regulations section 1.471-3
(ii) ☒ Lower of cost or market as described in Regulations section 1.471-4
(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ☒

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ☒

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d** _____

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☐ No
If "Yes," attach explanation.

Schedule B Other Information (see instructions)

	Yes	No
1 Check accounting method: a ☐ Cash b ☒ Accrual c ☐ Other (specify) ▶ _____		
2 See the instructions and enter the: a Business activity ▶ <u>5008 Distributor</u> b Product or service ▶ <u>heavy equipment</u>		
3 At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a statement showing: (a) name and employer identification number (EIN), (b) percentage owned, and (c) if 100% owned, was a qualified subchapter S subsidiary election made?		X
4 Has this corporation filed, or is it required to file, Form 8918 , Material Advisor Disclosure Statement, to provide information on any reportable transaction?		X
5 Check this box if the corporation issued publicly offered debt instruments with original issue discount ☐ If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.		
6 If the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) ▶ \$ _____		
7 Enter the accumulated earnings and profits of the corporation at the end of the tax year. \$ <u>37,200</u>		
8 Are the corporation's total receipts (see instructions) for the tax year and its total assets at the end of the tax year less than \$250,000? If "Yes," the corporation is not required to complete Schedules L and M-1		
9 During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions		

Schedule K Shareholders' Pro Rata Share Items

	Total amount
1 Ordinary business income (loss) (page 1, line 21)	1 119,000
2 Net rental real estate income (loss) (attach Form 8825)	2
3a Other gross rental income (loss) 3a	
b Expenses from other rental activities (attach statement) 3b	
c Other net rental income (loss). Subtract line 3b from line 3a 3c	
4 Interest income	4
5 Dividends: a Ordinary dividends 5a	4,000
b Qualified dividends 5b	
6 Royalties	6 16,000
7 Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	7
8a Net long-term capital gain (loss) (attach Schedule D (Form 1120S)) 8a	
b Collectibles (28%) gain (loss) 8b	
c Unrecaptured section 1250 gain (attach statement) 8c	
9 Net section 1231 gain (loss) (attach Form 4797)	9
10 Other income (loss) (see instructions) Type ▶ 10	

Form **1120S** (2010)

State S Corporation Tax Rules

Most states recognize S corporation status, but state corporation tax rules may differ from the federal tax law. Check with a local tax pro or your state's corporation office to find out your state's rules. Typically, states impose a minimum annual corporate tax or franchise fee that applies to all corporations operating in their state. Some states also tax S corporation income or gross receipts. California, a particularly tax-hungry state, imposes a 1.5% tax on all S corporation profits—and a minimum annual franchise tax of \$800—even if the corporation loses money. The bright side (if you can call it that) is that you can deduct any state and local taxes as business expenses on your federal corporate tax return.

How S Corporation Shareholders Are Taxed

S corporation profits and losses flow through to shareholders, but the tax code adds a twist.

Some items of S corporation income, losses, and deductions are separately stated on the shareholder's tax return. For instance, if an S corporation sells an asset at a gain, and it qualifies for long-term capital gains treatment, this is a separately stated item. The shareholder gets capital gains tax treatment (a present rate of 10%–15%). And, when the corporation elects Section 179, the Section 179 deduction flows through to each shareholder as a separately stated item. (IRC § 1366.)

An S corporation reports to the IRS each stockholder's proportionate share of its profit (or loss) on annual IRS Schedule K-1 forms. K-1s are given to each shareholder who then reports the K-1 figures on his or her annual individual Form 1040 tax return. As we all know, April 15 is the date for filing your individual income tax return,

including this K-1 data, unless you file for an automatic six-month extension.

S corporations must deposit employment taxes on all employee wages (see Chapter 6). Shareholders make four estimated tax payments per year on their S corporation income (the same as sole proprietors; see Chapter 7).

Profits

Typically, S corporation shareholders take profits either as wages or dividends. Either way—or even if all profits are kept in the S corporation bank account—the profits are tax-reported on Form 1040 annually by each shareholder. (This means an S corporation business owner's income is taxed like a sole proprietor, partner, or limited liability company member.)

EXAMPLE: Rusty's S corporation, Rustco, makes a profit of \$17,000. It issues a Form K-1 to Rusty, who owns 100% of its stock, reporting \$17,000 of income. Rustco, the corporation, owes no income tax. Instead, Rusty enters the \$17,000 on his tax return and pays taxes according to his overall income tax bracket.

Losses

S corporation operating losses flow through to individual shareholders. The loss can offset the shareholders' other income, lowering their tax bill. The operating loss is claimed on the shareholder's individual tax return, Form 1040.

A shareholder can't deduct a loss greater than his or her tax basis in the stock. Generally, a shareholder's tax basis is the total of money and property contributed plus any loans made by that individual to the corporation.

EXAMPLE: Jerrie paid \$5,000 for 100% of the stock in her S corporation, JerriCo, when she

incorporated. In its first year of operation, JerriCo lost \$7,000, which was reported on its Form 1120S corporate income tax form and on Jerrie's Schedule K-1. Jerrie can claim only \$5,000 as a loss, because this is the amount of her basis (investment) in her S corporation stock. (We'll assume the other \$2,000 is owed to the creditors of JerriCo.)



TIP

Lending money to your S corporation can increase your loss deduction. If a small business S corporation needs more capital, the shareholder-owners can lend money to it. A loan increases the shareholder-lender's basis in his or her stock. So, if the operation loses money, the shareholder-lender's tax loss can also increase—up to the amount of the loan. If the corporation makes money, the loan can simply be repaid to the shareholder. All shareholder loans must be properly documented. For more information on S corporation loans, and for promissory notes and corporate resolutions, see *The Corporate Records Handbook* or *Corporate Loans: Create Promissory Notes and Resolutions* (an eGuide), both by Anthony Mancuso (Nolo).

Material Participation

As an S corporation shareholder, you must materially participate in the business to deduct losses against other income. Merely being an investor in an S corporation doesn't cut it; you must be active in the operation. If challenged by the IRS at an audit to show material participation, you'll be okay if any of the following is true:

- you put in at least 500 hours per year working in the business
- you worked at least 100 hours, if no other shareholder puts in more time, or
- the facts and circumstances show that you worked on a regular, continuous, and substantial basis. (IRC § 469 and Reg. 1.469.)

Home Office Deduction for S Corporation Owners

There is a potential pitfall for S corporation owners with a home office. Sole proprietors and single-member LLC owners claim all their business deductions, including the home office deduction, on Schedule C of their individual income tax returns. (See Chapter 14 for rules on deducting home offices.)

S corporation owners, on the other hand, are considered employees of their corporation, so they can't file a Schedule C. Instead, their home office expenses are classified as "unreimbursed employee expenses" for tax purposes and claimed on Schedule A. This means that home office expenses are subject to a restrictive "floor" on miscellaneous itemized deductions, and some are lost.

But not to worry, there is a simple fix. The S corporation should adopt an accountable plan to reimburse the S corporation owner for the business use of his or her home. (You must do this with a written corporate resolution and follow certain rules.) If 25% of the home is used for business, the S corporation can pay 25% of the amount that would be allowable as a home office deduction under the home office rules. The S corporation then takes the deduction, and it isn't counted as income to the home/business owner. This works whether the home is rented or owned.

Social Security and Medicare Taxes

Congress wants all small business owners—whether solos, partners, LLC members, or shareholders—to pay the same amount of Social Security and Medicare taxes. For S (and C) corporation owner-employees, these are called payroll, or employment, taxes and are paid by the corporation to the IRS. (See Chapter 6 for details on how these taxes are paid and reported.)

Sample Schedule K-1

Schedule K-1
(Form 1120S)
Department of the Treasury
Internal Revenue Service

20XX

For calendar year 2010, or tax
year beginning _____, 2010
ending _____, 20____

Shareholder's Share of Income, Deductions,
Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
123456789

B Corporation's name, address, city, state, and ZIP code

Geeko Tech Games Inc.
4340 Holmes Parkway
Metro City, OH 43704

C IRS Center where corporation filed return

Cincinnati

Part II Information About the Shareholder

D Shareholder's identifying number
987654321

E Shareholder's name, address, city, state, and ZIP code

Gobi Gamer
666 Galaxy Way
Farout, OH 99999

F Shareholder's percentage of stock
ownership for tax year 100.000 %

For IRS Use Only

Final K-1 Amended K-1

671110 OMB No. 1545-0130

Part III Shareholder's Share of Current Year Income,
Deductions, Credits, and Other Items

1	Ordinary business income (loss)	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
11	Section 179 deduction 10,800	16	Items affecting shareholder basis
12	Other deductions		
		17	Other information

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S.

Cat. No. 11520D

Schedule K-1 (Form 1120S) 2010

Part 2
The Structure of Your Business

For noncorporate business owners, these are called self-employment taxes and are paid quarterly along with their estimated tax deposits. This Social Security and Medicare tax is reported annually on Schedule SE filed with the business owner's individual tax return. (See Chapter 7.)

While salaries and bonuses paid by an S corporation to employees are hit with employment taxes, corporate dividends are not subject to payroll or employment taxes. This presents a tax savings opportunity: If you work in your S corporation, you must take some compensation as salary if the business is profitable. However, taking a combination of salary and dividends reduces an owner's overall tax bill, as the example below illustrates.

EXAMPLE: Gordon manages his S corporation, Wham Bam Inc., and pays himself an annual salary of \$42,000. The employment tax rate for Gordon is 13.3% (2011 rate). Gordon also takes \$14,000 from Wham Bam as a dividend on his stock. If the \$14,000 dividend was labeled as salary or a bonus instead, Gordon would have to pay an additional \$1,862 in employment taxes (13.3% of \$14,000).



CAUTION

IRS auditors may question low

S corporation owner salaries. It hasn't escaped the notice of the IRS that S corporation owners minimize their self-employment taxes by taking dividends. If you are audited and the IRS claims your dividends were really wages, you'll have to show your salary was reasonable. One way to show this is to compare compensation paid to managers of similar businesses. As a rule of thumb, a 70-30 split should pass IRS muster (70% wages; 30% dividends).

Electing S Corporation Status

Before choosing S corporation status, run it by a tax pro. If you decide to do it, here's how:

- File IRS Form 2553, *Election by a Small Business corporation*. You'll find a filled-in sample in this chapter. Get the current form by calling 800-829-FORM (1040), or from the IRS's website at www.irs.gov, or an IRS office, or your tax pro. Don't file Form 2553 until your corporation has been formed.
- Meet the filing deadlines. File Form 2553 with the IRS no later than the 15th day of the third month after your corporation's taxable year begins—for example, if you begin on January 1, file by March 15. If you miss the deadline, contact the IRS and ask permission to file it late under Rev. Proc. 2004-48. If you miss the deadline in one year, you can elect S status in the next year.
- Have Form 2553 signed by whoever is authorized to sign the corporation's tax returns—usually the president.
- Get written consents from all shareholders (or known prospective shareholders). Also have each person sign Form 2553 in the appropriate place. Unless every shareholder signs, your S election is invalid. In a newly forming corporation, have every potential shareholder sign. There is no penalty if someone who signs doesn't ever become a shareholder.
- Mail Form 2553 to the IRS address where you file your individual tax returns. The IRS should send you a written acknowledgment that you are an S corporation within 30 days.

Note: You may also have to file a tax election form with your state.

Revoking S Corporation Status

Once elected, S corporation status continues until revoked by shareholders holding more than 50% of the corporation's shares.

The IRS also can revoke your S corporation status for various corporate misdeeds, such as failing to file tax returns or keep corporate records.

There is no IRS form to revoke S status. Instead, send a “Revocation of S Status” letter to the IRS address where you file your tax return. State the name of the corporation, the tax identification number, and the number of shares outstanding. Have the letter signed by all of the shareholders. A sample letter is shown below.

Letter Revoking S Corporation Status

To: [Your IRS Service Center]

Dated: 12/20/2012

Re: Revocation of S corporation Status of Bone Corporation
Federal Identification Number #94-0000000

1. Bone Corporation hereby voluntarily revokes its prior election to be treated as an S corporation under IRC § 1362(d).
2. The revocation is to be effective January 1, 2013.
3. At the time of revocation there are 1,000 shares outstanding in the corporation.

Statement of Consent

The following shareholder, who owns all of the shares of the corporation, under penalty of perjury, consents to the revocation of the election of S corporation status:

Hamilton Bone
111 Main St., Juneau, AK
SSN 555-55-5555
1,000 shares acquired 1/1/1987

Hamilton Bone

Hamilton Bone
Shareholder

If a corporation revokes S status, it cannot be reinstated for five years. Once S corporation status is revoked, the corporation is taxed as a C corporation.

Dissolving an S corporation

When your S corporation calls it quits, it is liquidated. Shareholders receive whatever money or property the corporation owns. First, you must pay off all corporate debts before any remaining assets are distributed to shareholders.

Gains and losses on any assets distributed are passed through to shareholders—just as profits and losses from the operating business were. Each shareholder is then taxed on the difference between the fair market value of each asset and the basis of his or her stock. The shares of stock are then returned to the corporation and canceled. Here’s how it works:

EXAMPLE: Ted, the only shareholder of TYVM, Inc., an S corporation, decides to close up shop and move to Costa Rica. After selling its inventory and paying its bills, TYVM’s remaining asset is a patent on an injection molding tool. The patent rights, with a tax basis of \$1 million, are sold for \$2 million. The \$1 million gain is passed through to Ted and is taxed at a 15% capital gains rate, resulting in \$150,000 income tax. Ted may owe state income taxes as well.

It would be worse for Ted if TYVM had been a C corporation. Then, there would have been double taxation on the liquidation. First, the gain on the sale of the patent rights would be taxed to TYVM at the corporate rate of 34%. Then Ted would get taxed at 15% on his gain from the corporate liquidation.



TIP

Your final year tax filing. The Form 1120S tax return filed for the final year of operation should be checkmarked as a “Final Return” at the top of the first page. Otherwise, the IRS may keep the corporation in the tax reporting system for future years and send out delinquent return notices.

A tax return checkmarked “final” increases your corporation’s audit odds. See a tax pro whenever dissolving your S corporation, and take special care to file an accurate return.

S Corporations in a Nutshell

- Small business corporations, including S corporations, are formed under state law.
- S corporations are treated like partnerships and LLCs for tax purposes—the profits and losses pass through to the shareholders who report them on their individual income tax returns.
- S corporations must file annual informational tax returns—Form 1120S—with the IRS.
- All corporations begin life as a C corporation but may elect S status by filing an IRS form.
- S corporation status is often beneficial for start-ups because they frequently lose money in the first year or two and shareholders can take the business losses on their tax returns.
- S corporations can’t offer as many tax-advantaged fringe benefits as C corporations.
- Most states require tax reporting of S corporations operating within their borders and charge an annual franchise or income tax on S corporations.
- Dissolving an S corporation often results in taxable gains or losses to the shareholders if any assets are distributed.

Resources

- IRS *S Corporation Income Tax Package* (1120S, annually updated). Includes the current year’s tax forms and instructions. This package is available at IRS offices, on the IRS website (www.irs.gov), and by telephone at 800-829-3676.
- IRS Publication 542, *Corporations*.
- IRS Form 2553, *Election by a Small Business corporation*, and instructions.
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinncpas.com.

Partnerships

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“All taxation is evil.”

—Brooks Adams

You are probably familiar with the general partnership: two or more people running a business and splitting the profits or losses. Partners contribute money (or property) to form a partnership.

Each general partner is personally responsible for all of the debts and liabilities of the business, not just his or her proportionate share. An exception to this rule of personal liability is the limited partnership—however, most active small businesses are general, not limited, partnerships. See “Limited Partnerships,” below.

Your state’s laws govern partnership formation and operation. However, all states have adopted the Revised Uniform Partnership Act, so laws are very similar. Partnership tax rules are the most complex in the tax code. We only scratch the surface in this chapter.

The IRS reports that there were 3.5 million partnership tax returns filed in a recent year. This number includes some limited liability companies that file their taxes as partnerships.

One bit of good news—the IRS audit rate of partnerships is lower than for sole proprietors.



CAUTION

Partnerships happen automatically.

Partnership tax rules apply even when two people go into business on a handshake and never sign a formal partnership agreement. As long as costs and profits of a venture are split, a partnership exists as far as the IRS (and your state’s partnership law) is concerned.



CAUTION

A joint investment is not automatically a partnership. Two or more people owning an asset together is not automatically a tax reporting partnership. There must be an active business for a partnership. For instance, say Conrad and Constance co-own a warehouse that they rent to Big Box, Inc. This

is not necessarily a partnership for tax purposes unless the co-owners want to file as a partnership or they provide services in addition to renting the warehouse to Big Box, Inc. If in doubt, see a tax pro before determining your tax filing choices.

Partnership Tax Status

Partners are similar to sole proprietors; both report their share of the business’s profits or losses on their individual tax return. General partners pay self-employment tax (Social Security and Medicare) like sole proprietors.

Partnerships also bear a tax resemblance to S corporations and limited liability companies. All three are pass-through entities, which means that the owners—not the business—pay income taxes. Nevertheless, all three entities must file annual tax information returns, even though no tax may be due.



SEE AN EXPERT

Get help with partnership accounting.

When forming a partnership, you face immediate tax-related decisions. Right away, you must choose a method of accounting, the tax year, and the depreciation methods to adopt. While some initial tax decisions may be changed as your partnership goes along, others can’t be, so consult a tax pro. (See Chapter 4.)

Tax Reporting

An active business partnership must file a tax return each year, but does not pay federal taxes. (IRC §§ 701, 761.) Instead, a partnership’s profit or loss passes through to the individual partners. Each partner reports his or her share on his or her individual Form 1040 tax return (or joint return, if filing with a spouse).

A partnership accounts for income and expenses, obtains its own tax ID number, and files tax returns every year it is in operation.

Limited Partnerships

In a general partnership, each partner can obligate the partnership to any contract, debt, or other transaction.

Limited partnerships (LPs) are more complex and primarily used to raise money from passive investors (the limited partners) who will not be active in the business. LPs are common in real estate investing and private investment firms. LPs have two categories of partners: general partners, who are personally liable for all partnership obligations, and limited partners, who have no liability for partnership debts.

LPs may have to register with the state agency that regulates securities (in most states, the secretary of state or department of corporations) and, if offering shares to the public, with the federal Securities and Exchange Commission as well. For these reasons, LPs require professional help to set up and maintain.

LPs are sometimes found in the small business world as family limited partnerships.

The following examples illustrate the primary difference between general and limited partnerships.

EXAMPLE 1: Serendipity Partners, a limited partnership, owes \$17,000 to various creditors. Raul, the general partner, is personally liable for the whole \$17,000 if Serendipity goes under. This is the amount she can claim on her tax return as a loss if the LP fails.

EXAMPLE 2: If Serendipity was a general partnership, both Raul and Chessie would be liable for the whole \$17,000. Creditors could go after each partner's personal assets to collect the entire debt, not just \$8,500 each. Of course, the creditors would not be entitled to collect more than a total of \$17,000. If the partnership should fail, the tax consequences are more complicated than with limited partnerships.

Annual Partnership Tax Returns

The annual federal partnership tax return, showing the venture's income and expenses, is IRS Form 1065, *U.S. Partnership Return of Income*.

The tax return is due on the 15th day of the fourth month after the end of the partnership's tax year—April 15 for most partnerships. An extension to file is easy to obtain if you can't file by the deadline. Use IRS Form 7004 for the automatic extension of five additional months. A sample Form 1065 (page one only) is shown below.

Exception: Partnerships that only invest in property and don't carry on a business aren't required to file Form 1065. (See IRS Publication 541, *Partnerships*.) Of course, the individual partners have to report any income from the investments on their individual returns.

Even though Form 1065 is an information-only return, the IRS imposes fines for not filing it on time. The late filing penalty is \$195 per month for each partner and applies to each year the partnership form is delinquent.



SEE AN EXPERT

Get professional help with your partnership tax return. These are complicated forms and we strongly recommend that you not try to do this on your own.

State Partnership Taxes

Most states treat partnerships like the federal government does—that is, they tax individual partners, not partnerships. A state partnership tax return, similar to Form 1065, is usually required. Partnerships typically have to pay an annual tax or fee for the privilege of operating in the state. Check with a tax pro or your state tax department about the forms and fees required.

Partner's Profit or Loss Statements (K-1)

Partnerships issue an IRS Schedule K-1 to each partner annually (with a copy to the IRS). As discussed below, the K-1 shows each partner's share of income or loss, deductions, and credits.

The K-1 report is entered into IRS computers to cross-check the income of individual partners to make sure it gets reported on their personal tax returns. If there's no match, there will be an IRS inquiry.

Partnership Federal Identification Number

A partnership must obtain a federal tax ID number, called a Federal Employer Identification Number (FEIN), from the IRS. This ID number is required for all partnerships and is used on annual partnership tax returns (Form 1065s) and K-1 forms. (Instructions on how to get a tax ID number are in "Employer Identification Numbers" in Chapter 6.)

EXAMPLE: Brenda and Betty apply to the IRS for a tax ID number. They are assigned 94-1234567 as the Employer Identification Number of the B & B partnership. They must use the number on all partnership tax returns and K-1 form filings. They will most likely be required to use this same EIN for state tax filings, although some states issue separate partnership tax ID numbers.

Tax Obligations of Partners

Partners are not employees of their business. They don't receive wages, and the business does not pay payroll taxes on the partners' income. Instead, partners take out business profits through periodic draws or distributions and pay their taxes as individuals (Form 1040).

At the end of the tax year, each partner's share of business profits (or losses) is computed and reported on IRS Schedule K-1. This form shows each partner's share of income or loss, credits, deductions, and various other tax items.

Each partner reports his or her K-1 partnership income on his or her individual income tax return, Form 1040, using Schedule E. This income (or loss) is added to the rest of the partner's income from wages and investments for the year.

Often there are other figures on a K-1 that "pass through" from the partnership to the individual partners. For instance, the partnership may have earned interest on its bank accounts or received dividends from stock it owned in another business. These items are passed through and reported on Schedule B of the partner's individual tax return. Similarly, any partnership capital gains or losses on sales of assets are reported on the partner's individual tax return on Schedule D. Neither form is reproduced in this book, but both can be viewed at the IRS website (www.irs.gov) and are included in the annual Form 1040 income tax forms. Income tax software makes this process easier than it sounds.

Self-Employment Taxes

All general partners, like solos, pay self-employment taxes on their share of the partnership profits. Self-employment taxes are reported on Schedule SE, filed annually with each partner's Form 1040 tax return.

Limited partners (investors) don't owe self-employment tax, so they aren't required to file this form.

Estimated Income Taxes

Partners, like solos, must make quarterly estimated income tax payments on their share of the partnership income. These four tax payments are due on April 15, June 15, September 15, and January 15 of the following year. Partners use

Sample Form 1065—page 1

Form 1065 Department of the Treasury Internal Revenue Service	U.S. Return of Partnership Income For calendar year 2009, or tax year beginning _____, 2009, ending _____, 20_____. ▶ See separate instructions.		OMB No. 1545-0099 20XX
A Principal business activity Retail	Use the IRS label. Otherwise, print or type. Name of partnership Able Baker Book Store	D Employer identification number 10 9876543	
B Principal product or service Books	Number, street, and room or suite no. If a P.O. box, see the instructions. 334 West Main Street	E Date business started 10-1-79	
C Business code number 594	City or town, state, and ZIP code Orange, MD 20904	F Total assets (see the instructions) \$ 45,391	

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return
 (6) ☐ Technical termination - also check (1) or (2)

H Check accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ▶ _____

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ 2

J Check if Schedules C and M-3 are attached ☐

Caution. Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

Income	1a	Gross receipts or sales	1a	409,465		
	b	Less returns and allowances	1b	3,365	1c	406,100
	2	Cost of goods sold (Schedule A, line 8)	2	267,641	3	138,459
	3	Gross profit. Subtract line 2 from line 1c	3		4	
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)	4		5	
	5	Net farm profit (loss) (attach Schedule F (Form 1040))	5		6	
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)	6		7	559
	7	Other income (loss) (attach statement)	7		8	139,018
Deductions (see the instructions for limitations)	8	Total income (loss). Combine lines 3 through 7	8		9	29,350
	9	Salaries and wages (other than to partners) (less employment credits)	9		10	25,000
	10	Guaranteed payments to partners	10		11	1,125
	11	Repairs and maintenance	11		12	250
	12	Bad debts	12		13	20,000
	13	Rent	13		14	3,295
	14	Taxes and licenses	14		15	1,451
	15	Interest	15		16a	1,174
	16a	Depreciation (if required, attach Form 4562)	16a		16b	
	b	Less depreciation reported on Schedule A and elsewhere on return	16b		16c	1,174
	17	Depletion (Do not deduct oil and gas depletion.)	17		18	
	18	Retirement plans, etc.	18		19	
	19	Employee benefit programs	19		20	8,003
	20	Other deductions (attach statement)	20		21	89,648
	21	Total deductions. Add the amounts shown in the far right column for lines 9 through 20	21		22	49,370
22	Ordinary business income (loss). Subtract line 21 from line 8	22				

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

▶ Frank W. Able ▶ 3/12/20xx
 Signature of general partner or limited liability company member manager Date

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only	Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
	Firm's name (or yours if self-employed), address, and ZIP code		EIN ▶	Phone no.

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11390Z Form **1065** (2009)

Form 1040-ES to report and pay these estimated taxes. (See “Solos’ Tax Forms: Schedule C Is Your Friend,” in Chapter 7, for information on this form.)

If the partnership loses money, no estimated tax forms are required to be filed.

Estimated tax payments cover income and self-employment taxes (Social Security and Medicare).

State estimated tax forms and payments are also required for states with an income tax.

Calculating and Reporting a Partner’s Income

Accounting for a partner’s taxable income or loss is not always easy. For instance, the cash a partner takes out isn’t necessarily the same as that partner’s taxable income from the business. We explain this in more depth below, but the culprits here are the complexities of partnership accounting law.

Partnership draws are the most common way partners take money from their businesses. Tax-wise, draws are considered advances against a partner’s income. As we shall see, advances or draws show up on the partnership books as reductions of the partner’s capital account. At the end of the year, the total draws become taxable income if the draws exceed the partner’s investment in the partnership. This calculation can get tricky; consider going to a tax pro for help.

The distributive share

A partner is taxed on the amount he or she is deemed to have received from the partnership under complex tax accounting rules. (IRC § 704.) This is called a partner’s distributive share and is reported annually on IRS Schedule K-1.

A distributive share is normally based on the percentage of the partnership each partner owns—from 1% to 99%. Unless a partnership agreement says otherwise, the tax code presumes all partners are equal. If two people are in business

together without any written agreement, it’s always a 50-50 partnership.

EXAMPLE: Brenda and Betty’s partnership agreement calls for each to get 50% of the profits (or losses) of the B & B partnership. If B & B makes a profit of \$70,000, each partner has a distributive share of \$35,000 to report on her individual 1040 tax return. In reality, Brenda may have taken \$40,000 as a cash distribution and Betty may have taken only \$30,000. Each still must report 50% of the profits of the B & B partnership.

Special allocations

All partners are not created equal. If your agreement authorizes it, unequal distributive shares, called special allocations, may be made. A special allocation is a tax code term for any division of profits or losses that is not proportionate to a partner’s ownership percentage.

For instance, in the case of a 50-50 partnership, giving 65% of profits to Partner A and 35% to Partner B is a special allocation. A partnership agreement could also provide different ratios for splitting losses and profits, such as an 80-20 split for losses and 65-35 split for profits.

Partnership agreements can provide special allocations for any reason. For instance, one partner may work full time and others only part time, or one partner may have special skills or generate more income.

EXAMPLE: Betty plans to work more hours for B & B partnership than Brenda, who intends to spend part of her time authoring a travel book. The two agree in writing that Betty will receive 60% of the partnership’s profits. Betty’s distributive share of B & B’s \$70,000 profit is \$42,000, and Brenda’s is \$28,000. These are the amounts shown on their respective K-1 forms and reported on each of their individual tax returns.

Sample Schedule K-1

Schedule K-1
(Form 1065)Department of the Treasury
Internal Revenue Service

20XX

For calendar year 2010, or tax
year beginning _____, 2010
ending _____, 20Partner's Share of Income, Deductions,
Credits, etc.

▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
010101010

B Partnership's name, address, city, state, and ZIP code
Hair Raisers Partnership
10 Scalper Way
Mt. Baldy, NC 31111

C IRS Center where partnership filed return
Atlanta

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
123006789

F Partner's name, address, city, state, and ZIP code
Harry Headum
444 Elixir Street
Fringetop, NC 31111

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I What type of entity is this partner? Partnership

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	50,000 %	50,000 %
Loss	50,000 %	50,000 %
Capital	50,000 %	50,000 %

K Partner's share of liabilities at year end:

Nonrecourse \$ _____
 Qualified nonrecourse financing . . . \$ _____
 Recourse \$ _____

L Partner's capital account analysis:

Beginning capital account . . . \$ 222,000
 Capital contributed during the year . . . \$ _____
 Current year increase (decrease) . . . \$ 88,000
 Withdrawals & distributions . . . \$ (100,000)
 Ending capital account . . . \$ 210,000

☐ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?

☐ Yes ☐ No

If "Yes", attach statement (see instructions)

☐ Final K-1☐ Amended K-1

651110

OMB No. 1545-0099

Part III Partner's Share of Current Year Income,
Deductions, Credits, and Other Items

1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss) 44,000		
3	Other net rental income (loss)	16	Foreign transactions
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	18	Tax-exempt income and nondeductible expenses
11	Other income (loss)		
		19	Distributions
12	Section 179 deduction		
13	Other deductions	20	Other information
14	Self-employment earnings (loss) 44,000		

*See attached statement for additional information.

For IRS Use Only

A partner's tax bill depends on his or her overall tax situation—not just what that person gets from the partnership. It's unlikely that two partners will ever pay the same taxes. Special allocations may be used to sprinkle different tax benefits to partners for an overall tax savings.

EXAMPLE: Again, Brenda and Betty's partnership makes a profit of \$70,000. By the terms of their partnership agreement, Brenda gets a special allocation of a 60% distributive share of the profits, or \$42,000. With her other income, exemptions, and deductions, Brenda falls into the 25% tax bracket. So, her federal income tax on the B & B income is \$10,500.

Betty, on the other hand, has investment income plus the partnership income. Her share of the partnership profits puts her into the 35% tax bracket, so the tax due on Betty's distributive share of \$28,000 is \$9,800—almost as much as Brenda's tax on her share.

Without a special allocation there would have been a 50-50 division of partnership profits. Brenda would have paid \$8,750 and Betty \$12,250 in taxes—\$21,000, a total of \$700 more in federal taxes, plus any state taxes due.



SEE AN EXPERT

Special allocation rules are tricky. Your partnership agreement must provide for any special allocations. It's best to have an attorney write this provision for you after discussing it with a tax pro. (IRC §§ 703, 704, and Regs. 1.703, 1.704.)

Money left in the partnership

If a partnership keeps profits in the business at the end of the tax year, the partners are still taxed on that money. It doesn't matter to Uncle Sam that the partners never get their hands on the funds.



TIP

If your business needs to retain profits, consider incorporating. Taxwise, forming a C corporation may be the best way to keep profits for future expansion or to build your inventory. Remember that partnerships (as well as S corporations and limited liability companies) are tax pass-through entities. This means that any profits left in the partnership bank account—or as inventory—are taxed straight to the partners. C corporations can offer some relief from this tax bite through income splitting. (See Chapter 8 to see how this works.)

Partnership Losses

Partnership losses also pass through to each partner in proportion to his or her ownership share. However, a different allocation scheme may be written into the partnership agreement.

Partners can deduct their share of a business loss on their individual tax return. This lowers their tax bill by offsetting other income, and may even produce a tax refund.

EXAMPLE: Betty and Brenda formed the B & B Partnership. The operation lost \$40,000 the first year, largely because their bed and breakfast inn was not yet listed in travel guides. Brenda gets a distributive share of 60% of the loss (\$24,000) under their partnership agreement. Brenda may be able to use her \$24,000 B & B loss to offset her other income that year.

Passive partner limitations. If Evie is a silent or money partner—that is, she invested in a general real estate operating partnership but is not involved in its day-to-day affairs—she is a passive investor. Tax rules limit Evie's ability to claim partnership losses of more than \$25,000 per year from rental real estate activities. Paper losses are common in partnerships due to noncash expenses like depreciation deductions. (IRC § 469, Reg.

1.469.) If Evie's partnership loss is greater, she can carry the balance forward to offset her future passive income. This is called a suspended loss and may be carried forward to offset future passive income indefinitely. It's best to consult with a tax pro for details on this.

Partnership Contributions

When people form a partnership, they typically throw a combination of money, assets, and services into the pot. These contributions may have unexpected tax consequences, however, to the individual partners.



SEE AN EXPERT

Tax and accounting rules for partnerships are not simple. If your situation strays beyond the ones covered here, head for the resources listed at the end of this chapter or see a tax pro.

Keeping Track of Partners' Contributions: Capital Accounts

Each partner's contribution to the partnership is recorded in that partner's capital account. This means tracking the contributions and withdrawals of each partner, including his or her annual distributive share of income or losses from the partnership. Think of each partner's capital account as the partner's financial history, starting at the beginning and continuing through the life of the partnership.

A partnership interest is an asset of the partner—an investment in the business. You must track your investment in your partnership interest for as long as the partnership is in operation or holds any assets.

Keep meticulous records of all partnership contributions and distributions. This is vital for determining the tax consequences of taking money or property out of the partnership.

Your capital account balance is generally equal to your tax basis in your partnership interest. Your tax basis changes annually according to your distributive share of income and losses. Stick with me here and this will become clear.

The following example illustrates this point and one made earlier: that cash you take out of a partnership is not necessarily the same as your taxable income from the business.

EXAMPLE: In exchange for partnership interest, Moe contributes \$14,000 and six seltzer bottles (which cost Moe \$200) to the Stooges Partnership. So, \$14,200 is the amount of Moe's capital account balance and his initial tax basis in his partnership interest.

In the first year, Stooges Partnership makes \$30,000 and Moe is taxed on \$10,000 (his $\frac{1}{3}$ interest). The partnership distributes \$9,000 cash to Moe. His capital account is \$15,200 (\$14,200 + \$10,000 – \$9,000).

Cash contributions

When everyone contributes just cash for their partnership interests, then things are simple, taxwise. Each partner's capital account equals the amount of cash the partner contributed.

EXAMPLE: Curly puts \$11,000 cash (nothing else) into the Stooges partnership. His initial capital account balance is \$11,000.

Asset contributions

When transferring anything other than money—such as real estate, vehicles, or copyrights—to the partnership, more complicated tax rules come into play. Your existing tax basis in the asset transferred to the partnership becomes part of your tax basis in your partnership interest.

EXAMPLE: Ken transfers an office condominium he owns to VideoPro, a partnership

that he and Barbara are setting up to sell video conferencing equipment. In exchange for the office condo, Ken receives a 50% share of the VideoPro partnership. At the time of its transfer, Ken's tax basis in the condo (what he paid, minus depreciation, plus the cost of his improvements) was \$50,000. Ken's initial tax basis in his partnership share is \$50,000.

Real life is often more complex than this example. For instance, if real estate owned and contributed by a partner has changed in value between the date acquired and date contributed (very likely), the tax result changes as well. There could be built-in gain on any increase in value of the asset prior to transferring it to the partnership. However, there wouldn't be an immediate tax bite for anyone. Instead, taxes would be delayed until the property is either disposed of by the partnership or the partnership is dissolved.

EXAMPLE: Suppose Ken's office condo is worth \$100,000 when he contributes it to VideoPro partnership, instead of \$50,000 (Ken's basis). Two years later, VideoPro has outgrown the office and sells it for \$140,000. There are two tax results. First, Ken is taxed on \$50,000 of the initial gain (the difference between his basis and the condo's value at time of contribution). Second, Ken is taxed on \$20,000 of the \$40,000 increase in value after the contribution. (Barbara is taxed on the remaining \$20,000 gain.)

Contributions of services

Often one partner has cash, while another has only the expertise to make the business go. This may create a tax problem because services are not considered property when contributed to a partnership.

There's a tax cost if you take ownership in a partnership in return for a promise to work in the

business. You are taxed that year on the value of your partnership interest—it is income to you.

EXAMPLE: Brenda and Betty form the B & B partnership to operate a bed-and-breakfast inn. Betty has \$100,000 in cash but no business experience. Brenda has 20 years in the hospitality field but no money. If they are both 50% partners, Brenda is taxed on the fair market value of her 50% ownership. Since Betty contributed \$100,000, and Brenda (whom the IRS views as contributing nothing) received a 50% interest, Brenda owes tax on \$50,000 income at her ordinary individual income tax rate for that year.



TIP

Becoming a profits-only partner avoids this problem. Putting a profits-only partner clause in your partnership agreement can reward someone who wants to work but can't make a financial contribution. This clause states that the individual contributing services has no ownership, but gets a share of partnership profits—if any—in exchange for his or her work. (This profits-only partner can buy into the partnership later and become a full partner.)

EXAMPLE: Brenda and Betty draw up their partnership agreement stating Brenda is entitled only to 50% of the profits. Brenda is now a profits partner, and there is no tax to pay because she doesn't own a capital interest in the partnership.

Two additional tax code rules restrict the rights of profits partners:

- A profits partner can't sell his or her profits interest in the partnership within two years of receiving it.
- A profits partner can't be promised any fixed amount of money; that partner must bear a genuine risk of getting nothing if the partnership doesn't make a profit. (IRS Rev. Proc. 93-27 and Rev. Proc. 2001-43.)

A tax disadvantage to being a profits partner is that if the partnership suffers a loss, a profits partner—who may have put blood, sweat, and tears into the business—can’t deduct any of the loss on his or her tax return. Partnership tax losses can pass through only to the real partners (the owners), not the profits partners.

Adjustments to Partners’ Capital Accounts

Once a partnership begins, continual accounting adjustments must be made to each partner’s capital account. This is necessary for annual income tax reporting of each partner.

Numerous transactions require adjustments to capital accounts. Here are a few of the common ones:

- A partner contributes additional cash or property to the partnership. Contributions increase a partner’s basis in his capital account.

EXAMPLE: In June of the first year of business, the Sylvester & Son partnership needs operating capital. Sylvester puts in another \$10,000 (beyond his \$50,000 initial investment). The partnership breaks even in year one. Starting in year two, Sylvester’s tax basis in his capital account is \$60,000 (his \$50,000 initial contribution plus \$10,000 additional investment).

- A partner is entitled to a distributive share of partnership profits or losses. (These amounts are passed through to the individual partners and then reported on their personal tax returns.) A profit increases a partner’s tax basis; a loss decreases his basis.

EXAMPLE: Sylvester & Son partnership earns a small profit of \$2,000 in its second year. Sylvester is a 50% partner.

Thus, his \$60,000 capital account is increased by \$1,000 to \$61,000, by including 50% of the partnership’s profit.

- A partner withdraws money or assets. This is covered below in “Getting Money out of a Partnership.”

Partnership Liabilities

Not all financial transactions of the partnership change a partner’s capital account. For instance, a partner’s capital account is not affected by partnership debts.

EXAMPLE: Sylvester & Sons partnership borrows \$15,000 from Bus Bank to buy factory equipment. In the partnership books an asset of \$15,000 is added, but it is offset by a \$15,000 liability. Because of this wash, Sylvester’s capital account is unaffected.

Getting Money Out of a Partnership

Since you went into business to put cash in your pocket, let’s look at the tax effect of taking money from your partnership. Again, tax rules make this a bit complicated.

Taxation of Withdrawals

Let’s recap. Each partner has a capital account—maybe it’s \$100 or \$10 million. This figure represents the partner’s investment in the partnership business for federal tax purposes.

The tax basis in the capital account for each partner is continually adjusted through the life of the partnership by the partnership’s financial transactions. For instance, partnership losses decrease the partner’s tax basis; contributions by the partner increase it.

Withdrawals of money or assets from a partnership are first treated as a (nontaxable) return of your investment. Only after you have recovered your entire investment (meaning that your basis in your partnership interest has been reduced to zero) are withdrawals taxable to you.

EXAMPLE: Lola puts \$50,000 into Lola Partners. Business is good and Lola is entitled to a distributive share of \$10,000 of profits at the end of the year. She withdraws \$60,000 (her share of profits and her initial capital contribution). Lola will owe income tax on only \$10,000, the amount she received in excess of her basis (\$50,000). In effect, Lola would get back all of her contributions to Lola Partners, plus her share of profits. Her basis in her partnership interest (Lola's capital account) is reduced to zero at the beginning of the following year.

Loans to Partners

Partnerships can lend money to their partners. It's a way to get money out of your partnership—at least for the short term—without its being taxed. (Loans aren't income if there is a legal obligation to repay them.) Moreover, borrowing from your partnership doesn't affect your tax basis in your partnership interest.



CAUTION

A loan must meet tax code requirements.

You must sign a written, legally enforceable obligation to repay the partnership on a certain date and at a reasonable rate of interest. (See "Loans to Shareholders" in Chapter 8 for all of the legal requisites of a corporate loan, which apply to partnerships, too.)

Partnership Expenses

Tax rules for deducting expenses of a partnership are the same as for other businesses: an expenditure related to the trade or business is usually deductible. (See IRC § 162 and Chapter 2.) Expenses are shown on the partnership's tax returns (Form 1065), not on the individual partners' returns.

Selling or Transferring a Partnership Interest

When a partner disposes of his or her partnership interest, there are tax ramifications. A perusal of the following will likely convince you to hire a tax pro to guide you through the ordeal.

Selling Your Partnership Interest

Selling your partnership interest to another partner—or to anyone else—has no tax impact on the partnership. It's like a shareholder selling stock in a corporation—it doesn't affect the corporation one way or the other.

However, for the selling partner, there is likely a taxable gain or loss. Your basis in your partnership interest determines your taxable gain or loss.

The gain or loss is computed by subtracting your tax basis in your partnership interest from money (and/or property) you receive. If you have owned your partnership interest for over 12 months, your gain qualifies for long-term capital gains tax rates—a top tax rate of 15% on your profit.

EXAMPLE: Ken sells his VideoPro partnership interest to Jackie for \$75,000. Ken had initially put \$40,000 into VideoPro and contributed another \$15,000 when the business needed cash for expansion. Ken also took \$50,000 out

of the partnership over several years, which represented his distributive share of earnings on which he paid tax. All told, Ken's basis in his partnership interest was \$55,000 when he sold to Jackie.

$$\begin{array}{rcl}
 & \$40,000 & \text{Ken's original basis} \\
 + & 5,000 & \text{additional investment} \\
 + & 50,000 & \text{distributive share of earnings} \\
 & & \text{on which Ken paid tax} \\
 - & 50,000 & \text{withdrawals} \\
 = & \$55,000 & \text{Ken's adjusted basis}
 \end{array}$$

So Ken has a taxable gain of \$20,000 when he sells to Jackie (\$75,000 sales price less his \$55,000 basis).

Reporting sales to the IRS. When a partnership interest is sold or exchanged, the partnership reports it to the IRS on Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*. This form is filed with the annual partnership tax return (Form 1065).

When the Partnership Buys Out a Partner

If the partnership itself buys out your interest, the tax result is usually the same as selling to anyone else. The tax code calls this a retirement of a partner.

If you are the partner being retired, payments you receive from the partnership are treated first as a payback of your partnership capital account. In other words, you first get back your investment—with no tax consequences. Anything over your investment is a taxable gain to you. Anything less than your capital account is a tax deductible loss. A retirement has no tax effect on the remaining partners.

EXAMPLE: Starsky retires from the Starsky & Hutch partnership in return for \$60,000. Starsky's tax basis in his partnership interest is \$80,000. The \$60,000 Starsky gets from the partnership is a nontaxable return on his investment. The balance of his capital account, \$20,000, is deductible as a loss on his investment. (See Chapter 5 to see how Starsky can get a tax benefit from this loss.)

Relief of Debt—Phantom Income

One more tricky tax rule comes into play when you transfer a partnership interest. The amount of income you are taxed on when you sell your partnership interest includes—in addition to cash and any property you receive—your share of any partnership liability you are leaving behind.

For instance, if Luke's three-person partnership owes \$150,000 to its creditors when Luke retires, he is treated as receiving \$50,000 in income because he no longer owes that portion of partnership debt. This relief of debt income is not obvious to most of us. But it can produce an unexpected tax shock.

EXAMPLE: Brenda, a 50% partner in the B & B partnership, retires. Brenda takes partnership assets—a car worth \$10,000 and \$25,000 cash—in return for her share. Brenda is also relieved of \$20,000—half of the \$40,000 owed by B & B to its creditors. The tax code says Brenda got a total of \$55,000 (\$10,000 + \$25,000 + \$20,000) for her partnership interest.

Date-of-Sale Adjustment

When selling, your basis in your interest is adjusted for any partnership gains or losses for the year to date. Only if you sell on the last day of the partnership's tax year is this not an issue.

Partnership profits for that year to date must be reported on your individual tax return as ordinary income—not capital gain on the sale. Conversely, if it's a year-to-date loss, it is deducted from your basis and reduces your gain or increases your loss on the sale.

EXAMPLE: On July 1, Betty sells her 50% partnership interest for \$100,000. Her basis is \$50,000 on that date. The B & B partnership has a profit of \$40,000 as of July 1. Betty must report \$20,000, half of the profit, as her distributive share for that partial year. She also must report any gain or loss on the sale of her partnership interest. Betty owes regular income tax on the partnership profits (\$20,000) at a rate which could be as high as 35%. Betty's gain of \$50,000 on her partnership share, however, is taxed at her capital gains tax rate which is likely to be 15%.

Ending a Partnership

Unless a written agreement provides otherwise, a partnership automatically terminates upon the death or withdrawal of a partner.

All partnership assets—equipment, inventory, and any other property—are considered for tax purposes sold to the individual partners. (IRC § 708(b).) The value of the assets received is then calculated to see if there is a gain or loss for tax purposes.

If there is gain, tax is due on the difference between the partner's tax basis and the property's fair market value. This is true whether the partner sells or retains the asset.

If there is a loss, it may be claimed on the partner's individual tax return to offset other gains he may have.

A deceased partner's assets go into his or her estate, where they may be subject to estate tax. (See Chapter 13 for an explanation of estate tax.)

EXAMPLE: Ken dies, and his VideoPro partnership with Barbara terminates. Barbara takes the business equipment (a value of \$120,000) to use in a new business. Ken's estate takes the partnership bank account of \$120,000. At the date the partnership ends, Barbara's basis in her partnership interest is \$50,000. Barbara has a taxable gain of \$70,000 (\$120,000 value of equipment less her basis of \$50,000). Whether or not Ken's estate will have to pay taxes depends on the value of his estate.



CAUTION

You may need cash to pay your tax liability if you receive property when a partnership ends. Implicit in the above example is the danger of a tax liability without receiving the cash to pay it. If you take noncash assets—like real estate, that is hard to liquidate, or that you want to keep—make sure you have enough cash to pay the tax man.

Partnerships and IRS Audits

Partnerships are audited about one-third as often as sole proprietorships. The IRS apparently reasons that since partnerships don't pay taxes (partners do, remember), auditing them won't directly result in more revenue. Of course, if a business partner's tax return is audited, chances are the IRS will look at the partnership's tax return, too. And if problems are found—such as an improper tax deduction on the partnership tax return—it can lead to the audit of all the partners' income tax returns as well.

Partnerships in a Nutshell

- Partnerships arise automatically whenever two or more people go into business together.
- While partnerships do not pay income taxes, they should file an annual information tax return reporting income and expenses.
- Profits and losses of a partnership flow through to the individual partners, similar to a sole proprietorship, S corporation, and LLC.
- Partners report business profits or losses on Schedule E of their individual income tax returns.
- Partnership tax accounting rules are very complex and a tax pro should be brought in at the outset.
- Partnerships may allocate profits and losses unequally, which can be used to give tax benefits differently to each partner.
- Contributing services only in return for a partnership interest creates an undesirable tax situation (which can be dealt with).
- Terminating a partnership can result in tax liabilities for the individual partners—it's a good time to see a tax pro.

Resources

- IRS Publication 541, *Partnerships*.
- IRS Form 1065, *U.S. Partnership Return of Income*, and instructions.
- IRS Schedule K-1, *Partner's Share of Income*.
- *Form a Partnership: The Complete Legal Guide*, by Denis Clifford and Ralph Warner (Nolo). Contains a wealth of details about setting up and running a partnership business.
- IRS Publication 505, *Tax Withholding and Estimated Tax*.
- IRS Form 1040, Schedule SE, *Self-Employment Tax*, and instructions.
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinnccpas.com.

Limited Liability Companies

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“I stay within the law only because the law is maneuverable, it can be manipulated.”

—William M. Kunstler

An increasingly popular way to organize a small business is the limited liability company (LLC for short).

An LLC offers nontax advantages over a sole proprietorship, partnership, or a corporation. Unlike a sole proprietorship or general partnership, an LLC protects its owners’ personal assets from business creditors. LLC owners’ liability for business debts is limited to their ownership interest in the business—hence the name limited liability. Plus, all LLC members can take an active role in the operation of the business without exposing themselves to personal liability—unlike partners.

According to one nationally known small business expert, Gene Fairbrother, the LLC is far superior to either the sole proprietorship or partnership because of the limited liability feature alone. In the long run, Mr. Fairbrother says, “the LLC could be the least expensive insurance that you ever buy.”

Taxes

The LLC is a pass-through tax entity, like a partnership or S corporation. Owners (called members) report and pay taxes on LLC income on their individual tax returns and are responsible for filing and paying quarterly estimated taxes like sole proprietors and partners. LLC losses also pass through to the members and can be claimed on their tax returns for tax benefits. LLC members claiming losses must have “materially participated” in the business; they cannot just be passive investors.

Federal Tax Reporting

LLCs, like partnerships and S corporations, do not pay federal income taxes, so LLC income is taxed at a single level—to the members. Even though no taxes are due, LLCs and members have tax reporting duties:

- Members pay estimated quarterly taxes, file Form SE (Social Security & Medicare), and pay taxes like sole proprietors. (See Chapter 7.)
- The LLC is responsible for payroll taxes only for its nonmember employees. (See Chapter 6.)
- Single member LLCs (and husbands and wives in community property states) can report LLC income or loss on Schedule C, the same as a sole proprietor.
- Multimember LLCs typically file Form 1065, *U.S. Partnership Return of Income*, and issue each member a Schedule K-1 showing that partner’s share of LLC profit or loss. The person reports that amount on his or her Form 1040, individual income tax return. (See Chapter 10.)
- LLCs may choose to file corporate tax returns, although few do.

There are special rules for foreign LLCs that are not covered in this chapter.

State Taxes

States often tax LLCs, even though the IRS doesn’t. For example, in California, LLC taxes and fees range from \$800 to as much as \$12,000. Most states require annual tax reporting by LLCs on their own state forms.

Unequal Allocations of Profit and Loss

LLC profits and losses pass through the LLC and are allocated and taxed annually to the LLC

members. Or, put another way, the LLC owners, not the LLC itself, are responsible for paying income taxes on business profits.

The percentage of income or loss allocated to each LLC member is stated in the LLC's operating agreement. In a one-member LLC, of course, all income and loss will pass through to the sole owner.

However, an LLC may allocate profits (or losses) disproportionately to its members. These are called special allocations. An LLC can allocate profits unequally only if it meets some technical tax code rules. This means special language in your LLC operating agreement. This is tax pro stuff—not for do-it-yourselfers.

Comparing LLCs With Other Entities

LLCs are attractive because they combine the pass-through taxation of a partnership or sole proprietorship with the limited liability of a corporation. So, if the business is sued or incurs obligations it can't meet, a creditor can only go after business assets—not property belonging to the members. Hence, the term “limited liability.”

One exception: The IRS (and probably your state tax authority, too) can collect delinquent LLC payroll taxes directly from members.

This limited liability feature is the reason most folks choose an LLC. Here's a summary of how LLCs stack up against other entities:

- **Sole proprietorship.** An LLC can be a one-man band, but owners aren't personally responsible for nontax LLC debts, as are solos.
- **General partnership.** A multimember LLC usually elects to be taxed like a partnership. But LLC owners aren't personally liable for nontax business debts as are general partners.
- **Limited partnership.** Limited partners, like LLC members, are shielded from personal

liability for business debts. However, LPs can lose this protection if they participate in the management of the business. Limited liability company members have no such restrictions on participation. Plus, each limited partnership must have at least one general partner with full personal liability for business debts.

- **S corporation.** LLCs and S corporations are both tax pass-through entities, so profits and losses flow through the business to its owners. LLCs are less formal and cheaper to operate than corporations. LLCs can allocate income and expenses to their members disproportionately; S corporations must allocate income and expenses according to the shareholders' percentages of ownership. There's no limit on the number or types of owners (members) an LLC can have. By contrast, an S corporation may have no more than 100 shareholders. And S corporation shareholders can't be nonresident aliens—which rules out any foreign shareholders. Because LLCs aren't under the ownership restrictions of S corporations, it may be easier for them to bring in more members to raise capital.
- **C corporation.** As separate entities, C corporations offer shareholders protection from business creditors. However, C corporations—unlike LLCs—are taxpaying entities, which could mean double taxation of profits. Also, the liquidation of a C corporation may trigger corporate and shareholder taxes. An LLC liquidation will usually only have tax consequences to the members. In addition, an LLC can be run less formally than a corporation.
A C corporation can keep some of its earnings in inventory or in cash for future growth at a tax rate as low as 15%. LLC members, on the other hand, can't leave profits in the business without first paying

taxes on these profits at their individual tax rates, which might be as high as 35%.

Professional Limited Liability Partnerships and LLCs

Many states allow certain professionals to form professional LLCs, but a few states call them limited liability partnerships (LLPs). Only certain state-licensed occupations—such as doctors, lawyers, and accountants—may form these professional LLCs or LLPs. (For example, in California only accountants, lawyers, or architects may form LLPs.)

The designation LLP (or RLLP, Registered Limited Liability Partnership) becomes part of a firm's name and must be used in all legal transactions and advertising to the public. Once registered, the partners of the LLP do not have liability for the malpractice of the other partners, but remain liable for their own acts. This limited liability feature—not taxes—is the primary reason why professionals form LLPs.

If you provide professional services, check with your state or your attorney for LLC and LLP restrictions and requirements.

Operating Your Limited Liability Company (LLC)

As with most business entities, LLCs are formed and regulated under state law. Many states have adopted the Uniform Limited Liability Company Act. However, LLC procedures, paperwork, and expenses vary from state to state. Most, but not all, do not restrict ownership of LLCs, so members may include individuals, corporations, other LLCs, and even foreign entities. What follows is generally true for all states, but yours may be an exception.

Forming an LLC

To form an LLC, you'll need to prepare written articles of organization (some states call this a certificate of formation or certificate of organization) and send them to your state's filing office, often the secretary of state. The articles may be just a simple one-page form, similar to articles of incorporation.

Fees. The filing fee depends on your state and ranges from \$50 on up. (Tax-hungry California charges \$70 plus a minimum \$800 annual tax.) Most states provide a blank articles form on their secretary of state or department of corporations website.

Extra steps. Some states require a few extra steps before your LLC can start business. In New York, for instance, you must publish notice of your LLC formation in a newspaper. Also, you may need a local business or occupational license, a sales tax permit, or other local license.

Operating agreement. A written agreement (called an operating agreement) may also be required by your state. The operating agreement sets out the internal rules for governing the LLC members: voting rights, check-signing authority, profit sharing, responsibilities, ownership transfers, and other vital matters. This is akin to a partnership agreement or bylaws that govern a corporation.

Even if a written LLC operating agreement is not required by your state, it is certainly a good idea. It helps avoid or settle disputes about the management of the LLC business later down the road.



RESOURCE

See *Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo), for help creating an LLC. Also, check Nolo's online legal forms for help creating an LLC online (available for certain states only).

Documenting decisions. Most states' LLC laws don't require corporate formalities such as keeping minutes, passing resolutions, or holding annual meetings. However, it's wise to document the LLC's major actions, such as entering into an expensive executive employment agreement.



SEE AN EXPERT

LLCs can elect to file as a corporation. LLCs (as well as partnerships) can choose either pass-through taxation, like an S corporation, or to be taxed like a C corporation. (It would be unusual for an LLC to want to be taxed like a C corporation, however.) If you're interested, talk to your tax pro and see IRS Form 8832, *Entity Classification Election*.

Where to Get Help

Check with your secretary of state's office for LLC fees and filing rules. Most states provide sample LLC articles or fill-in articles forms.

See the "Resources" box at the end of this chapter for recommendations on legal self-help references. Business lawyers can help you form an LLC, and tax pros can do the IRS and state tax reporting. Attorneys' fees are about the same as for forming a partnership or corporation—ranging from \$500 to \$2,500.

If you are forming a one-person LLC, you can easily do it without a lawyer, but you should seek professional help if there are other members. Again, see the "Resources" box at the end of this chapter.

Tax ID number. After forming a multi-member LLC, you must get a federal identification number (EIN), unless you're a sole owner with no employees. See "Employer Identification Numbers" in Chapter 6 for details on how to get an EIN.

A few types of businesses can't be LLCs, such as banks, insurance companies, and nonprofit organizations.

Converting a Business to an LLC

There may be tax issues when you change from a solo or partnership to an LLC. You are likely to have tax consequences if you convert an existing corporation to an LLC.

The tax code requires that a corporation must be formally liquidated before its assets can be put into an LLC. Liquidating a C corporation with significant assets might mean taxes for the corporation, because this is treated as a sale of the corporation's assets. Then the funds from the sale of assets are deemed to have been distributed to the shareholders, who may be taxed again. (See Chapter 8.) Whatever is left after taxes goes into the LLC. A relatively new C corporation, or one that has not been successful or has minimal assets, may be able to convert to an LLC without a tax cost.

If you convert an S corporation to an LLC, you'll fare better, because any taxes on liquidation are placed only on the shareholders. There is no double taxation, as with C corporations.



SEE AN EXPERT

Get tax advice before switching. Bottom line: If you are tempted to convert your business to an LLC, see a tax pro first.

LLC Members' Rights

LLC members are not required to be involved in managing the business. They can be passive investors. This is similar to a limited partner or the holder of nonvoting corporate stock. However, there are some legal rights an LLC member must hold (such as the right to vote to dissolve the LLC). Check your state's LLC statute or talk with your legal adviser if you want to restrict the rights of certain LLC members.

Transferring Ownership— Sale or Death

Sale. Unless restricted in the LLC operating agreement, transferring an LLC ownership interest is relatively easy—the member simply signs over his or her membership interest. The buyer or transferee gets all the rights (and obligations) of the departing member.

The tax consequences to the transferring member are the same as with a partnership—the gain or loss is determined by the member’s tax basis in his LLC share. (See “Selling or Transferring a Partnership Interest” in Chapter 10.)

Small business LLCs don’t want a member forced on them. LLC operating agreements typically contain restrictions on transfers of LLC interests (called buy-sell provisions). An agreement often states that a retiring or departing member of an LLC must first offer his or her shares to the remaining members before selling to anyone else. Usually, a predetermined price for a share or a formula for valuing it is set out in the operating agreement. These buy-sell provisions bind all members and should be agreed upon during the LLC formation process.

Death. The IRS becomes interested when a member dies. That’s because an LLC interest is an asset in the estate of the dearly departed member. If the estate is big enough, there may be an estate tax return to file. See Chapter 13 for estate tax basics.

The good news is that the IRS usually respects the terms of a well-drafted buy-sell agreement (or an LLC operating agreement with buy-sell provisions) for fixing a fair price of a member’s share. See *Business Buyout Agreements: Plan Now for Retirement, Death, Divorce or Owner Disagreements*, by Anthony Mancuso and Bethany Laurence (Nolo), for more information on setting a fair price for LLC membership interests.



CAUTION

Tread carefully when estate-valuing an LLC. Valuation of business interests is a number-one concern to an IRS estate tax auditor. Many estate executors end up in IRS battles over just what a small business interest is worth. (See *Stand Up to the IRS*, by Frederick W. Daily (Nolo), for more information about estate tax audits and business valuations.)

Terminating a Limited Liability Company

Generally, the rules for terminating or dissolving an LLC are similar to closing up a partnership.

Income tax treatment of the members is the same as if they were general partners. (See “Ending a Partnership” in Chapter 10.)

Limited Liability Companies in a Nutshell

- The limited liability company (LLC) shields the personal assets of its members from business creditors, similar to a corporation.
- Like S corporations and partnerships, LLCs are not taxpaying entities.
- An LLC is a simpler, less expensive business entity to set up and maintain than a corporation.
- State law governs the formation and operation of LLCs.
- LLCs are usually taxed like general partnerships—as pass-through entities—meaning that the profits and losses pass through to the individual LLC members.
- Single-member LLCs are treated like sole proprietors by the IRS and the solo member usually reports LLC income on Schedule C of his or her individual tax return.
- Multimember LLCs usually file Form 1065, a partnership informational tax return.
- Any state in which an LLC operates may require annual reporting and impose an annual tax on LLCs.

Resources

- IRS Publication 3402, *Taxation of Limited Liability Companies*, available at www.irs.gov.
- IRS Publication 541, *Partnerships*, available at www.irs.gov.
- *A Guide to Limited Liability Companies* (Commerce Clearing House) and *The Limited Liability Company*, by James Bagley (James Publishing). These are technical books written for CPAs and attorneys.
- *Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo). This book provides step-by-step forms and instructions for setting up an LLC without costly legal fees.
- *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo). This book provides ongoing help on running your LLC, as well as numerous minutes and resolution forms.
- Nolo's Online Legal Forms at www.nolo.com to create your LLC online.
- IRS Form 8832, *Entity Classification Election*. Treasury Regulation 301.7701-3.
- Jeffrey A. Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinnccpas.com.

Qualified Personal Service Corporations

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“There is no magic in parchment or in wax.”

—William Henry Ashhurst

Many professionals—physicians, lawyers, accountants, and others who perform personal services—operate as sole proprietorships or partnerships, and go by the same tax rules as these entities. However, certain professionals can choose to form a special entity called a professional corporation. A professional corporation’s shareholders perform services for the corporation as its employees.

Each state regulates various professions and determines who may—or may not—form a professional corporation. For example, a group of attorneys and paralegals may not form a single professional corporation if under their state’s laws a nonlawyer can’t hold stock in a professional legal services corporation.

Most, but not all, professional corporations are classified by the federal tax code as qualified personal service corporations (QPSCs) and are taxed as C corporations, with a few twists. Generally, QPSCs don’t save taxes for owners.



TIP

Limited liability partnerships (LLPs) are now allowed in many states. LLPs, a relatively new form of business, provide an alternative to the professional corporation for professionals in states that allow LLPs, like California.

Qualified Personal Service Corporations (QPSCs)

A qualified personal service corporation is one in which substantially all of the activities involve services in the fields of health, law, engineering, accounting, architecture, actuarial science, performing arts, or consulting.

IRS regulations elaborate on the allowed occupations. For example, health care

professionals include physicians, nurses, dentists, and others, but not people who operate health or exercise clubs. Consulting covers someone who sells advice, but not a salesperson or any kind of broker. Performing arts covers actors, entertainers, and musicians but not their promoters or managers. Interestingly enough, professional athletes are not allowed to form PSCs. (Reg. 1.448-1T(e)(4).)



CAUTION

All PSCs aren’t QPSCs. A professional corporation isn’t always treated as a QPSC. (IRC § 448.) If a professional corporation doesn’t qualify as a QPSC, it is taxed as a general partnership. (See Chapter 10.)

IRS Tests for a QPSC

The IRS imposes two tests a corporation must meet to be taxed as a qualified personal service corporation. These tests focus on what the corporation does (the function test) and how it’s owned (the ownership test).

Function Test

To be a QPSC, substantially all of the activities of the corporation must involve rendering personal services. IRS regulations say that “substantially all” means 95% or more of work time expended by employees. (Reg. 1.448-1T(e).)

EXAMPLE: Jack and Jill are fresh out of law school, but they cannot find full-time work as attorneys. To keep bread on the table, they form an S corporation, Sweetstuff, Inc., to operate a frozen yogurt store. In addition, they do freelance legal work for about ten hours a week. Can they convert their S corporation into a PSC? No, because as Sweetstuff, Inc., employees, Jack and Jill don’t devote 95% of their time to providing legal services.

Nontax Benefits of Professional Corporations

Professionals typically incorporate for nontax reasons. For instance, like any corporation, a professional corporation has perpetual existence. So if one shareholder dies or withdraws, the business can carry on with minimal legal disruption, unlike a partnership.

Professional corporations also offer shareholders limited personal liability. (The extent of this protection depends on state law.) However, incorporated professionals can't legally escape personal liability for their own negligent acts—for this you need professional liability insurance. But a shareholder practicing with other professionals can usually avoid personal liability for other shareholders' malpractice or misdeeds.

EXAMPLE: Allison and Bill, both psychiatrists, form a professional corporation, sharing a receptionist and other common expenses. If Dr. Bill loses a malpractice lawsuit, both the corporation's assets and Dr. Bill's personal assets are in jeopardy. However, Dr. Allison will not be personally liable—meaning her house and savings cannot be grabbed to pay the judgment. If, on the other hand, they operated as a general partnership, Dr. Allison would be personally liable for Dr. Bill's acts in their practice of medicine.

Ownership Test

Substantially all stock (95% or more) in a QPSC must be held directly or indirectly (through one or more partnerships, S corporations, or other qualified PSCs) by one of the following:

- employees performing professional services for the corporation
- retired employees who performed services in the past
- the estates of such individuals, or

- someone who inherited stock from any such persons.

EXAMPLE: Ralph and Connie are physical therapists who are approached by Gino, the owner of Costa La Health Spa, to offer services at the spa. If Ralph and Connie will incorporate as a professional corporation with him, Gino will invest \$20,000 in return for some stock. They incorporate as Spa Time Inc., with Ralph and Connie owning 75% of the stock and Gino 25%. Spa Time Inc. does not qualify as a QPSC under the 95% ownership rule, because Gino, who is not a health professional, owns more than 5% of the stock.

QPSCs and Taxes

A QPSC is a separately taxed entity and is taxed at the flat rate of 35% of its net income. In reality, as with most small business C corporations, QPSCs don't pay income tax because all profits are usually paid out to shareholders as salaries, bonuses, and fringe benefits. The shareholders then pay income taxes on their tax returns, leaving the QPSC with nothing to be taxed.

Alternatively, a QPSC may elect to be income-taxed as an S corporation, but this is not common (see Chapter 9).

The individual states tax PSCs (IRS-qualified or not) at varying rates. Typically, states impose a minimum annual franchise tax on PSCs ranging from about \$50 up to \$800.

A QPSC can keep its records on either a calendar-year or fiscal-year basis. (See Chapter 4.)

However, a QPSC must get IRS permission to use a fiscal year by showing a business purpose for it. (Rev. Procs. 87-32 and 87-57 have details and examples.) To apply for permission from the IRS to use a fiscal year, file IRS Form 1128. It's better to have a tax pro do this for you.

Accounting Method Elections

A QPSC may keep records using either the cash or accrual method. (See “Timing Methods of Accounting: Cash and Accrual” in Chapter 4.)

Section 1244 Stock

A QPSC may adopt Section 1244 status, as long as it has not elected to be an S corporation. This allows advantageous tax treatment to shareholders if they ever sell their stock for a loss. (See Chapter 5.)

Fringe Benefits

A QPSC may offer many of the fringe benefits available to a C corporation. (See Chapter 15 and Chapter 16 for a discussion of corporate fringe benefits.)

A QPSC may elect to be an S corporation, but if it does, it won't qualify for the fringe benefits discussed below. Moreover, the tax code does not provide PSC shareholders the same flow-through tax treatment that S corporation shareholders get.

Tax-Advantaged Retirement Plans

A QPSC may establish corporate retirement plans, including 401(k)s.

Health and Life Insurance Benefits

A QPSC with three or more shareholders may establish a Voluntary Employees' Beneficiary Association (VEBA). This allows the QPSC to deduct the cost of health and life insurance coverage to all PSC employees as a tax-free benefit. VEBAs are usually administered by banks or insurance companies. (See IRC § 501(c)(9) for details, or consult a tax or pension professional.)

Other Fringe Benefits

QPSCs can offer tax-advantaged life and disability insurance, death benefits, dependent care, and other fringes, without establishing a VEBA.

Alternatives to the Professional Corporation

Some states recognize professional limited liability companies (LLCs) as an alternative to the professional corporation. Other states (such as California, Delaware, Louisiana, and Texas) allow professionals to form a similar business entity called a limited liability partnership (LLP). See Chapter 11 for more information about forming an LLC or LLP.

Transferring Shares

State laws typically prohibit transferring PSC stock to a nonprofessional. This also would violate the IRS requirement that “substantially all stock be held by those who are actively performing services.”

QPSCs should have written agreements, binding on both the shareholders and their estates, requiring the purchase of deceased shareholders' stock by the QPSC. Often, buy-sell agreements are funded by a life insurance policy. The QPSC takes out life insurance policies on shareholders and uses the payoff to buy the deceased owner's share from his or her estate.

Dissolving a Qualified Personal Service Corporation

A QPSC ends by a majority vote of the shareholders. A QPSC may also be dissolved by the state or as a result of legal action against it.

Taxes on dissolving a QPSC are roughly the same as for a C corporation. The important thing to know is that a taxable gain (or loss) for each shareholder results when a QPSC folds. See a tax pro for guidance through this process.

Qualified Personal Service Corporations in a Nutshell

- Certain professionals who want to incorporate their practice can do so by forming a professional corporation in their state.
- The federal tax law has special provisions for incorporated professionals called Qualified Personal Service Corporations (QPSCs).
- A QPSC must provide services in fields such as health, law, engineering, accounting, architecture, and the performing arts.
- For a professional, incorporating offers a limited liability shield and a greater range of fringe benefits.
- At least 95% of QPSC stock must be owned by employees performing services for the corporation.
- A QPSC must file a tax return and its net income is taxed. However, QPSCs typically owe no taxes because they pay out all earnings as salaries, bonuses, and fringe benefits.
- States usually impose a minimum annual franchise tax on QPSCs.
- There may be taxes on the dissolution of a QPSC if there are any assets to distribute to the shareholders.

Resources

- IRS Publication 542, *Corporations*.
- Jeffrey Quinn, CPA, is a knowledgeable tax professional who assisted in the preparation of this chapter. He can be contacted at www.ashleyquinnpcpas.com.

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“Don’t tax you, don’t tax me; tax the fellow behind the tree.”

—Senator Russell B. Long

Many small businesses get the whole family involved. Parents bring children into a business to help and to teach the kids money-making skills. When the children grow up, they may take over the family business and then pass it on to their offspring.

While the tax rules discussed in previous chapters also apply to family businesses, there are additional tax pitfalls and opportunities unique to family businesses.

The Legal Structure of a Family Business

Either spouse can own a sole proprietorship. However, if other family members share ownership, the business must be organized as a partnership, limited liability company, or corporation.

These more complex forms of doing business offer families more tax and estate planning flexibility than sole proprietorships. For instance, incorporating allows family members to receive ownership benefits (such as stock dividends) even if they don’t work for the enterprise. Or, forming a family limited partnership or LLC makes it easier to transfer business ownership to family members gradually over time and save both income and estate taxes.

Families can even combine several different types of business structures to best distribute tax benefits. For instance, a partnership with several siblings can own and rent a building to a corporation owned by their parents. Whether or not multiple entities make sense depends on the tax situations of all the family members. This requires the help of a savvy tax pro.

Generally, whether the complications of forming several entities are worth it hinges on the income splitting ideas discussed below.

Income Splitting Lowers Taxes

Family members often pool their resources to run small businesses. For many, this provides not only a good living, but also a sense of security and closeness. As a bonus, family ventures can also bring tax savings for the family unit.

One technique known as income splitting shifts income from higher bracket taxpayers—usually parents—to lower bracket ones—usually children or retired grandparents. Obviously, these strategies depend on cooperation and trust between family members.

Legality of Hiring Your Kids

It’s perfectly legal to hire family members to work in the business for a salary. Courts have supported parents hiring their minor children as long as they give them real work to do. Employing kids or other relatives is okay—as long as the pay isn’t outrageous and you comply with your state’s child labor laws.

Tax Benefits of Hiring Your Kids

Putting your children to work in your business can reduce your family’s tax bill. Paying your kids reduces the business profits that would otherwise be taxed at your tax rate (which is always higher than your kids’ rates).

A minor can earn up to \$5,700 without owing income taxes to the IRS. Then, the tax rate starts at 10%. As long as the income is earned by a child who works in the family business, the kiddie tax (tax on a child’s investment income discussed below) doesn’t apply. And the parent can still claim the child as a dependent.

Besides Junior’s lower tax bracket, no FICA (Social Security and Medicare) taxes are due when he works for Mom or Dad’s business. Ditto for FUTA (federal and state unemployment) taxes when Junior is under 21. In other words, there’s no tax cost for putting Junior on the payroll. (IRC

§ 3121(b)(3)(A), IRC § 3306(c)(5).) Assuming Junior saves up or uses the money for things the parents would be buying anyway, this is money in the family piggy bank.

EXAMPLE: Laura, a single mother and the sole proprietor of PhotoLand, earns \$380,000 per year, putting her in the 35% tax bracket. Her 17-year-old daughter, Louisa, helps out after school, on weekends, and all summer. Louisa is paid \$14,000 over the year.

Louisa files a Form 1040 tax return, taking a standard deduction. She owes \$830 (nothing on her first \$5,700 of taxable income and 10% on the remainder) in income taxes and no FICA tax.

If Laura hadn't hired Louisa, and instead took the \$14,000 in income herself, she'd pay

additional taxes of \$5,276 (\$4,900 in income taxes at 35% tax rate plus an additional \$376 in self-employment taxes—2.9% for Medicare).

Total family federal tax savings: over \$6,000. The tax deal can be even better if Louisa opens an IRA (see just below), or if their state has an income tax.



TIP

Save even more with an IRA for your child.

An individual retirement account can be established for any working child who earns wages. Up to \$5,000 can be put aside each year tax-deferred—meaning that Junior may earn \$5,700 without owing any income taxes. Income over that amount is taxed starting at the lowest income tax rate, 10%.

Paying Your Children Legitimately

Courts have okayed kids as young as seven getting paid for simple chores like taking phone messages or cleaning the office windows. Children can be paid a reasonable sum for their work; reasonable pay depends on the facts and circumstances of each case. My advice: Don't try to pay and deduct more than a few thousand dollars per year to any of your children under age 12.

EXAMPLE: Dr. Moriarty (his real name—not Sherlock Holmes's nemesis) hired his four teenagers to do clerical work for his medical practice. An IRS auditor said this was a mere subterfuge to deduct the kids' allowances as a business expense. The tax court overruled the IRS, saying it was all legal as long as the kids did real work and were paid reasonable wages. (*James Moriarty*, TC Memo 1984-249.)

Type of work. The kind of work done by the child—such as washing the company car, filing, or going to the mailbox—doesn't matter, as long as it's

a task a business customarily would pay someone to do. Duties should reflect the age and training of the children. While it is fine to pay a 14-year-old to do computer inputting, it wouldn't wash for an eight-year-old. But it's okay to hire your precocious 13-year-old to do filing even if you might not hire someone else's 13-year-old for the job.

Rate of pay. Generally, don't pay your child more than you would a stranger, although there is some wiggle room. If you pay little Susie \$7 per hour, and you could realistically find someone else to do it for \$5.50, an auditor will likely let it pass. But you are pushing the envelope if you pay her \$20 per hour.

Schedule of pay. The payments to your kids should match up to a work schedule. This can be tied to school vacations, after-school time, or holidays. If you make only one or two lump sum payments in a year, an auditor might think that you are trying to fudge on your taxes instead of legitimately paying Junior for work.

Putting money into an IRA makes tax sense even if the child takes it out long before retirement, say for college. (See Chapter 16 for details on IRA rules.)

Making Your Kids Co-Owners

You can also shift business income from higher-bracket family members to lower ones by giving your children stock in an incorporated business. Children don't have to work in the family business with this income-splitting technique.

Stock ownership is treated as an investment in the business, even if the child didn't pay for the stock. The primary drawback to giving your children stock is that you must irrevocably transfer the stock to them. You have no legal right to take it back later.

Children can receive dividends on their shares of stock in the corporation. Dividends are taxed according to how old the kids are, with a break for kids under 19 and up to age 24 for full-time students. An under-19-year-old child's investment income up to \$1,900—such as income from stock dividends in a family-owned corporation—is taxed at the child's tax rate. This is the so-called kiddie tax, which applies to children who don't work in the business. Anything over \$1,900 is taxed at the parent's tax rate, which could be as high as 35%. The first \$950 of the child's investment income is exempt from tax.

For more information, see IRS Publication 501, *Tax Rules for Children and Dependents*.



CAUTION

C corporation family businesses. Watch out for double taxation. A family C corporation paying dividends has already incurred corporate income tax on this money, so overall tax savings may vanish. (See "Double Taxation of Profits" in Chapter 8 for a discussion of the taxation of corporations.)



TIP

Give nonvoting stock. If you are the cautious type, give your kids only shares of nonvoting stock. Otherwise, they will be entitled to vote in the management of the business—including whether they will get any dividends each year.

EXAMPLE: Wally and Wanda own House of Shoes, Inc., and give their three children each \$26,000 worth of stock every year (\$13,000 from each parent). The gift is not subject to federal gift tax. The children's stock is nonvoting, so Wally and Wanda maintain control of the management of the House of Shoes, Inc. See the discussion in "Preserving a Family Business After Death," below, about estate and gift tax basics and transferring shares to your kids.

Putting Older Parents on the Payroll

Income splitting also works between older parents and their grown children. For example, a builder who might otherwise help his retired father financially could hire his dad part-time for light work. Not only does the business benefit from the expense deduction, but the father's pay is likely to be taxed in a lower bracket. Of course, shifting income to parents makes sense only if they are in a lower tax bracket and need the income.

Before hiring Mom, see what effect earnings will have on her Social Security benefits. If she's under full retirement age, her benefits may be reduced (see "How Working Affects Social Security Benefits," below).

Compensation received by a person on Social Security is still taxable and subject to FICA (Social Security and Medicare) tax.

How Working Affects Social Security Benefits

People who collect Social Security at age 62 or anytime before the year in which they reach full retirement age will lose one dollar of those benefits for every two dollars they earn over an annual IRS yearly limit.

Age	Annual Earnings Limit	Reduction in Benefits
62 through 66	\$14,160	\$1 for every \$2 earned

(These amounts are for 2011, and are subject to an annual cost of living adjustment in subsequent years.)

EXAMPLE: Marina started drawing Social Security benefits at age 62. She went to work for her son, Manny, at his Motel Five as a part-time desk clerk. In 2009, Marina earned \$14,400. She will lose \$120 in Social Security benefits under the tax code rules ($\$14,400 - \$14,160$, divided by 2 = \$120).

If Marina continues to work after reaching full retirement age, she won't lose any Social Security benefits, no matter how much she makes. Other income—investments, annuities, private pensions, unemployment, gifts, and rents—don't count toward the \$14,160. However, Marina's wages will continue to be subject to Social Security and Medicare taxes.

A Spouse in the Business

Before 2007, the tax law required married couples who jointly owned a business to file taxes as a business entity—a partnership, limited liability company, or corporation. There is now another tax reporting alternative. A couple in business together can file as a sole proprietorship—by

each attaching Schedule C to their individual tax return each year. (See Chapter 8 for an explanation of this form of doing business and Schedule C.)

As a practical matter, many if not most mom and pop operators don't want the hassle of forming and reporting as a separate business entity. Who can blame them for wanting to keep it simple taxwise?

The not-so-obvious issue here is that the law says that all of a business's workers must pay Social Security and Medicare taxes. If the individual is a sole proprietor or partner, this is called the self-employment tax. If the person's an employee, it is part of the payroll tax. Either way, it adds a 15.3% (13.3% for 2011) tax cost on the worker's pay for income up to \$106,800, and 2.9% on everything earned over that.

So, a spouse working in the business adds a tax cost to the operation and other costs as well, such as state unemployment and disability taxes and workers' compensation insurance. There is a way to get around this added cost, if it is within your tax comfort zone, discussed below.

There are two ways for two spouses working together and not forming a separate business entity to tax report:

- one spouse can volunteer, without pay, or
- the spouses can file taxes as co-sole proprietors.

Let's take a closer look at both options.

Letting Your Spouse Volunteer

There are no Social Security or Medicare expenses for working spouses who don't get a paycheck. Technically, this is wrong, but I have never seen any government agency, including the IRS, try to force a working—but unpaid—spouse onto the business's payroll. This is a fact of business life for many mom and pop operations that want to keep it simple. I call this “volunteering” in your spouse's business.

EXAMPLE: Susie Sanders earns \$110,000 from her SS Personnel Services business. Susie hires Jocko, her hubby, full time and pays him \$20,000 a year. Putting Jocko on the payroll increases the Sanderses' joint tax bill by \$3,060 (Social Security and Medicare tax of $15.3\% \times \$20,000$). By contrast, if Jocko had not been paid for his work (thereby increasing Susie's income by \$20,000), the family would have the same income tax bill but come out ahead about \$2,500 (\$3,060 – \$580, the amount of Medicare tax that Susie would have had to pay on the extra \$20,000 income). This example assumes Susie and Jocko file a joint tax return, which most spouses do.



CAUTION

Watch out for Social Security issues. An unpaid spouse won't get Social Security account credit. This is not a problem if the spouse has either already qualified for coverage from a former job by working at least 40 quarters (ten years) or qualified for survivor benefits.

File Taxes as Co-Sole Proprietors

Co-owner spouses can elect to file two Schedule C forms each year. Each spouse reports his or her share of the business's profits (or loss), typically 50%, on his or her Schedule C. There can't be any other business owners, such as kids or outsiders and both spouses must actually work in the business.

Each sole proprietor spouse must file a separate self-employment tax form (Schedule SE), and pay Social Security and Medicare taxes on his or her share of the business income. So, there is a tax cost, as opposed to when a spouse works without pay. But, both spouses receive Social Security and Medicare credits for their earnings. And both spouses can contribute to retirement plans if they are on the payroll.

Preserving a Family Business After Death

We can only touch on a few ways to pass on a business at death to minimize or avoid taxes. For details on estate planning, see the "Resources" list at the end of this chapter.

Anyone with a business may be concerned about:

- keeping the operation going after his or her death, and
- preventing estate taxes from taking a huge share of the business's assets or forcing its liquidation.

Choosing an Estate Tax Strategy

Lawyers and financial planners can often find loopholes to avoid or greatly reduce estate taxes for small businesses. One way is to create a marital bypass trust (AB owners trust), charitable trust, or some other type of legal structure known by acronyms such as GRITS, GRATS, and QTIPS. This area is fraught with tax peril; the best strategy for you depends on your personal and financial situation. Have an estate planning lawyer guide you. Below, we discuss some of the other, less sophisticated ways to keep small businesses in the family after the death of the owner.

Death and Taxes

A successful small family enterprise often becomes so valuable over time that estate taxes may be due upon the death of the owners. Roughly speaking, your taxable estate is everything you own at your death, less your debts. For 2011, the top estate tax is rate is 35% with an exemption from the tax for any estates valued at \$5 million or less. See "Estate and Gift Tax Basics," below, for more on the estate tax exemption.

EXAMPLE: Stella, a widow, dies in 2011. Her estate has a net value, after debts, of \$6.75 million. Because the estate tax exemption for 2011 is \$5 million. Stella's estate is taxed on the balance (\$1.75 million).

Most states impose estate taxes as well. Since there is a federal estate tax credit for any state estate taxes paid, combined federal and state estate taxes usually don't exceed the federal tax alone. However, a few states impose estate taxes higher than the federal credit—which can be significant in multimillion-dollar estates. If this worries you, check with an estate planning professional or tax pro. You may want to change your state of residence if your state's estate taxes are particularly onerous.

Estate taxes can be more than 40% when you combine federal and state tax rates. To pay taxes, executors may be forced to sell the business or its assets. However, there are several planning opportunities that can keep the business out of the clutches of the tax man, discussed below.

Installment Plans for Estate Taxes

Here's a tax break that lets families avoid business liquidations on the owner's death: a long-term estate tax payment plan. The interest rate charged by the IRS on tax for the first \$1 million due is only 2%, and 4% on any balance. An estate with a small business worth at least 35% of the estate's total value can pay estate taxes over 14 years. And for the first five years, the estate is allowed to pay interest only. (IRC § 6166.)

EXAMPLE: Jorge suddenly dies, having a will but no other estate planning. Jorge's Plumbing Supplies, is valued at more than the estate tax exemption. Jorge's will leaves the business to his two sons, but there isn't enough money for the estate taxes. Choosing the installment payment option, Jorge's sons can keep the business. They can pay the estate tax out

of future profits over 14 years at a favorable interest rate of 4%.

Although the installment plan helps business owners' families, Jorge might have been able to eliminate estate taxes altogether. We'll discuss some ways to do this next.



CAUTION

Joint ownership doesn't avoid estate

taxes. There is a widespread misconception that joint ownership of property avoids estate and gift taxes. This is only true for married couples. Adding a child's name to a deed or stock certificate may avoid state probate expenses, but it doesn't remove an asset from the reach of the federal estate tax. The only possible exception would be if the joint owner contributed funds to purchase the property. See "Estate and Gift Tax Basics," below.

Transferring a Business Before Death

Strategies for keeping a family business going after the death of an owner include forming a corporation, family limited partnership, or LLC. Each requires preplanning; deathbed transfers may not pass IRS muster. Several types of trusts are mentioned, but aren't appropriate for the typical small business.

A family business corporation

Incorporating a business makes it easier to pass it on and continue operation after the owner's death. And incorporating also provides a way to minimize estate taxes that is not available to sole proprietors.

With a corporation, a parent can give his kids the business stock in a series of annual gifts. As long as the value of the stock given to each recipient each year is no more than \$13,000, the transfer is not taxable to anyone. This is true

whether the business is an S or C corporation. For a valuable business, this is obviously a long-term planning device, because of the annual \$13,000 limitation. However, married co-owners can give a total of \$26,000 per recipient, which helps a little.

Giving corporate stock, however, is more complicated than giving cash. Each time you give corporate stock, you must determine its fair market value. Valuing a private company's stock requires the help of a CPA or business appraiser. If the IRS ever audits, it is doubtful it will just take your word for the stock's value—the auditor will probably want to see a professional opinion.



TIP

Giving away small business corporation stock doesn't mean relinquishing control of the business. An owner may transfer stock but keep the voting rights of the shares. A parent-owner could put children's stock in a trust and reserve the right to vote the shares.

Family Limited Partnerships (FLPs) or Limited Liability Companies (LLCs)

Instead of incorporating your family business, you can form a family limited partnership (FLP) or an LLC. An FLP is taxed like a limited partnership. (See Chapter 10 for a discussion of limited partnerships and Chapter 11 for a discussion of LLCs.)

Typically, parents form an FLP or LLC and transfer existing business assets to this entity. A venture can, however, be formed as an FLP or LLC right from the start.

FLPs and LLCs can minimize or avoid estate taxes and help business owners shift current business income to (lower bracket) family members.

In a family limited partnership, the parents are usually the general partners. Children are limited

partners, with an ownership interest in—but no right to manage—the operation. In an LLC, the children receive nonvoting membership interests.

As with corporation stock, each child can receive an ownership interest worth \$26,000 per year (from a set of two parents) as a gift, without tax consequences to anyone. (See “Estate and Gift Tax Basics,” below, about the annual exclusion rule for gift taxes.)

With an FLP or LLC (as with a corporation), business owners can gift ownership of a business to others (usually children) over a period of years. This can lower the estate tax bite, especially if the business is appreciating in value. Given enough time, as much as 99% of the parents' business can be transferred to the children tax free, leaving little or nothing subject to estate tax. Mom and Pop can maintain their income and remain in full control, deciding how annual profits are to be split among their kids. An FLP or LLC can be a win-win tax deal for the family business.

EXAMPLE: Wally and his wife Wanda, who are in the highest income tax bracket (35%), form an FLP to own and operate North Oxon Pottery. They give each of their three children—who are all in the lowest income tax bracket—limited partnership interests in the business over a number of years. (As long as the interest given by the parents to each child is worth under \$26,000 each year, there is no gift tax concern.) The children, as limited partners, have no say in the day-to-day affairs of the business.

Over 25 years, Wally and Wanda give most of North Oxon Pottery FLP ownership to their kids, while controlling the business until they are ready to step down. If planned right, when Wally and Wanda have both died, their remaining partnership interest is minimal, and their estates won't owe estate tax on the entire value of the business.

Estate and Gift Tax Basics

Estates

Federal estate taxes are due if you leave an estate valued at \$5 million or more in 2011 and 2012. The tax rate for those two years is 35%.

There is no federal inheritance tax; beneficiaries of an estate do not owe tax on anything they inherit. Instead, the estate pays the tax, if any, before the property is distributed. Only if the estate tax isn't paid can the IRS come after the beneficiaries for tax on their inheritances.

Unlimited Marital Deduction

One break for married couples is that when the first spouse dies, everything that person owned can be left to the surviving spouse (if a U.S. citizen) free of estate tax. This is called the unlimited marital deduction. Of course, when the surviving spouse dies, the estate is fully taxed if it's over the threshold amount for that year.

Gifts

You can't beat the estate tax by giving your assets away before you die, with one exception—the annual exclusion rule. Here's how it works. Generally, all gifts you make while you are alive are considered part of your taxable estate at death. However, the annual exclusion rule allows every person to give up to a certain amount every year (\$13,000 in 2011) to as many people as he or she wants to. These gifts can be in cash or any kind of property, and nothing has to be reported to the IRS by the giver or receiver. A rare tax freebie for one and all.

If you give away more than \$13,000 in cash or property to an individual in a calendar year, the

excess is subtracted from your lifetime estate tax exclusion. You must file a federal gift tax return for that year, but no tax is due until you have given away more than your lifetime exclusion amount. The \$13,000 gifts do not count toward the lifetime exclusion amount.

EXAMPLE: John & Julie Johansen have assets worth \$8 million. They want to transfer as much as possible to their kids and other relatives without a tax effect. They gift money annually to their two kids, two nephews, one grandchild, and one old friend. The Johansens can give away \$156,000 tax-free each year to these folks ($6 \times \$13,000$ for John and $6 \times \$13,000$ for Julie) under the annual exclusion rule. These annual gifts don't count against John or Julie's estate tax exclusion. If they live long enough, the Johansens may be able to reduce their estate so that no estate taxes will be due.

A few other kinds of gifts are tax free as well, regardless of the amount:

- gifts to your spouse (limited to \$110,000 if the recipient is not a U.S. citizen)
- gifts to tax-exempt charities, and
- gifts for tuition or medical expenses.



CAUTION

Congress may have changed the estate tax by the time you read this. Check with a tax pro or the IRS website for any updates.

Tax-Discounting the Value of a Family Business

The tax law allows you to discount the value of small business interests transferred by gift or on death. Reduced valuations can produce tremendous gift and estate tax savings, particularly when ownership is passed from one generation to the next. The reduction, called a marketability or minority discount, applies to family corporation stock, family limited partnership shares, or limited liability company shares.

The IRS routinely allows discounts of 15%–20% and discounts as high as 50% where the interest is minority, or the corporate stock lacks voting rights, or if it is a limited partnership interest.

A 1995 tax court case (*Bernard Mendelbaum v. Commissioner*, TC Memo 1995-255), involving a family-owned S corporation, discussed the factors the court looked at in determining the size of the discount. Let's look at these factors and their significance. My comments (in parentheses) follow each point:

1. Whether the stock has been traded publicly (insignificant; hardly ever the case in a small business).
2. Financial statement analysis (fairly important; best done by an experienced tax pro, mainly to see how profitable the business is; if only average or marginal, a larger discount can be taken).
3. Dividend policy (usually insignificant; most small corporations don't pay dividends).
4. Nature, history, and industry position (not too significant; how the business is positioned for competition and like factors).
5. Strength of company management (important; successful businesses depend heavily on personalities).

6. Degree of control in the transferred shares (very important; if the transferor maintains control after the transfer—typical with small businesses—large discounts can be justified).
7. Stock transfer restrictions (very important; for example, first refusal clauses, which make it very difficult to sell partial ownership).
8. Required holding period of stock (important; a stock transfer restriction; see #7 above).
9. Stock redemption policy (important; if the business has not historically redeemed stock of shareholders, this factor allows larger minority discounts).
10. Public offering costs (insignificant; few businesses worth less than \$10 million ever consider a public offering).

EXAMPLE: Juan, a widower, owns 70% of the stock of Star-Tar, Inc., which manufactures Spanish guitars. Juan's five children, all active in the business, own the other 30%. A business valuation expert values Juan's corporation at \$2.3 million. If Juan starts on an estate plan to give each of the children \$13,000 worth of stock every year, after 12 years he will have probably given away a majority interest in the corporation. Because of the discount allowance for family corporate stock, the value of Juan's new minority stock interest could be discounted. Depending on the value of his other assets, Juan's estate may not owe any estate taxes. (The same analysis holds true if Juan forms a family limited partnership or LLC instead of a corporation.)

**CAUTION**

You can't use an FLP or LLC solely to beat income or estate taxes. An FLP or LLC must have a business purpose with reasonable prospects of profitability, not merely holding a family investment. For example, an FLP or LLC formed to own a family vacation home isn't considered an active business, unless it is also used to produce rental income. Likewise, an FLP or LLC that holds an investment portfolio of marketable securities doesn't qualify for tax benefits.

FLPs and LLCs also protect the personal assets of the business owners from any business creditors. The owners can lose only the value of their business interests to creditors—not their personal bank accounts, homes, and so on.

**SEE AN EXPERT**

See a tax pro. If you are considering forming an FLP or LLC for passing on a family business, see a tax or estate planning attorney. But unless your business is worth at least \$1 million, an FLP or LLC may not justify the legal and accounting fees and state-imposed costs. Steer clear of trust scheme promoters who don't have a local office.

Employee Stock Ownership Plans (ESOPs) for C Corporations

Another tax-wise but complicated option for passing a small business corporation to the next generation is an Employee Stock Ownership Plan (ESOP for short). ESOPs are sometimes offered as a fringe benefit to employees of big corporations, but they also can work for small-timers, too.

ESOP rules under IRC § 404 are very complex; we can only skim the surface here.

Small business ESOPs typically work like this: A C corporation (S corporations don't qualify) makes annual contributions of its stock (or cash) to an ESOP trust. The trust is set up under

tax code rules similar to corporate retirement plans, discussed in Chapter 16. Over time, stock ownership passes to the beneficiaries of the trust, the company employees. Employees have account balances in the ESOP in proportion to their salaries.

EXAMPLE: Blowhard Corporation stock has a total value of \$1 million. It pays out \$500,000 in salaries to employees in the year in which the company establishes an ESOP. The tax code allows Blowhard to make an annual contribution of up to 25% of all employees' salaries to the ESOP, or \$125,000, to purchase corporate stock. This represents 12.5% of the stock of the company. Joe Blowhard, Jr., received a \$120,000 salary, so he has 3% of Blowhard stock allocated to his ESOP account at the end of the year ($\$120,000 \div \$500,000 \times 12.5\%$).

Blowhard, Inc., gets a tax deduction for the value of the stock contributed, and it is not income to the beneficiaries of the ESOP. If the company had simply given the stock to the employees, without using an ESOP, the stock would have been taxable income to the recipients.

The main drawback of an ESOP is that it must be offered to everyone—it cannot keep out long-term employees who aren't family members.

**SEE AN EXPERT****ESOPs are not do-it-yourself plans.**

First, only a C corporation can set up an ESOP. Hire a sharp CPA or a tax attorney to do it (their fees will be deductible to the company). Also, figure in the costs of annual appraisals of the value of the company while an ESOP is in place. Generally, owners should be approaching retirement, say in five to ten years, for an ESOP to make the most sense, and only in a business worth \$1 million or more.

Family Businesses in a Nutshell

- Family businesses allow tax savings through income splitting between parents and children or other relatives.
- Hiring your minor kids or retired parents is legal and can lower your tax bill.
- A spouse as co-owner of the business has both tax advantages and disadvantages.
- Incorporating or forming a family limited partnership or LLC is a way to transfer a valuable family business over time and eliminate or reduce the estate tax.
- Generally, there is no estate tax if a business interest is left to the surviving spouse.
- You may discount the value of transferred business interests within the family for tax savings.

Resources

- IRS Publication 554, *Tax Guide for Seniors*.
- IRS Publication 950, *Introduction to Estate and Gift Taxes*.
- IRS Publication 929, *Tax Relief for Children and Dependents*.
- *Plan Your Estate*, by Denis Clifford (Nolo). This is a thorough overview of estate planning options and strategies, including federal and state estate taxes.
- *Make Your Own Living Trust*, by Denis Clifford (Nolo). This book contains forms and instructions for creating two kinds of trusts: simple living trusts that avoid probate and a more complicated AB trust to reduce estate taxes.
- *Quicken WillMaker Plus* software (Nolo). This program lets you make probate-avoidance living trusts as well as an AB trust to reduce estate taxes.
- *Social Security, Medicare & Government Pensions*, by Joseph L. Matthews with Dorothy Matthews-Berman (Nolo). This book explains, among other things, the rules that govern taxation of Social Security benefits.
- Smartmoney.com. This site has a tax calculator to answer the question, "Will I owe estate taxes?" It's a good starting point, but if your estate is sizable, you'll want to run the answers by a tax pro.

Home-Based Businesses

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“Of course there’s a different law for the rich and the poor; otherwise who would go into business?”

—E. Ralph Stewart

According to the U.S. Bureau of Labor Statistics, over 18 million Americans operate home-based businesses. Quite a few of these ventures supplement a regular job or another business. The book in your hands was written in my home office.

Most tax rules are the same whether your business has 500 employees or it’s just you, working alone from home. Nevertheless, a few tax code restrictions are aimed at small enterprises that look more like hobbies than profit-seeking ventures.

This chapter focuses on sole proprietorships, which make up at least 75% of all businesses, but most of these principles apply to any type of unincorporated business. If your business is incorporated, see Chapter 8 and Chapter 9 as well.

Business Expenses Incurred at Home

Business expenses are tax deductible, no matter where they are incurred—at home, on the road, or in a traditional office or shop.

Home office expenses include:

- office supplies
- materials
- professional and trade memberships and dues
- travel
- business use of your auto
- meal and entertainment expenses
- insurance premiums for business assets
- local and long-distance telephone calls on the home phone (but not the cost of the basic monthly service)
- maintenance and repair of office computers and other equipment

- depreciation (or Section 179 write-off) of furniture and other business assets
- interest on business debts
- employee wages and benefits
- publications and software, and
- advertising.

(See IRC § 162, Reg. 1.162, and Chapter 2 for details and examples of other expenses.)



TIP

You can claim business expenses incurred in the home without a real home-based office. You may deduct all of the above business expenses whether or not you qualify for the home office deduction discussed below.

The Home Office Deduction

With a home-based business, you may be able to deduct part of your rent or take a depreciation deduction if you own your home. This tax break is commonly called the home office deduction. The home-based activity can’t be a hobby or to manage your investments, like a stock portfolio.

Over two million people claim a home office deduction, according to the IRS. Undoubtedly, more people could legally claim the deduction, but don’t know how or are scared they will be audited if they do.

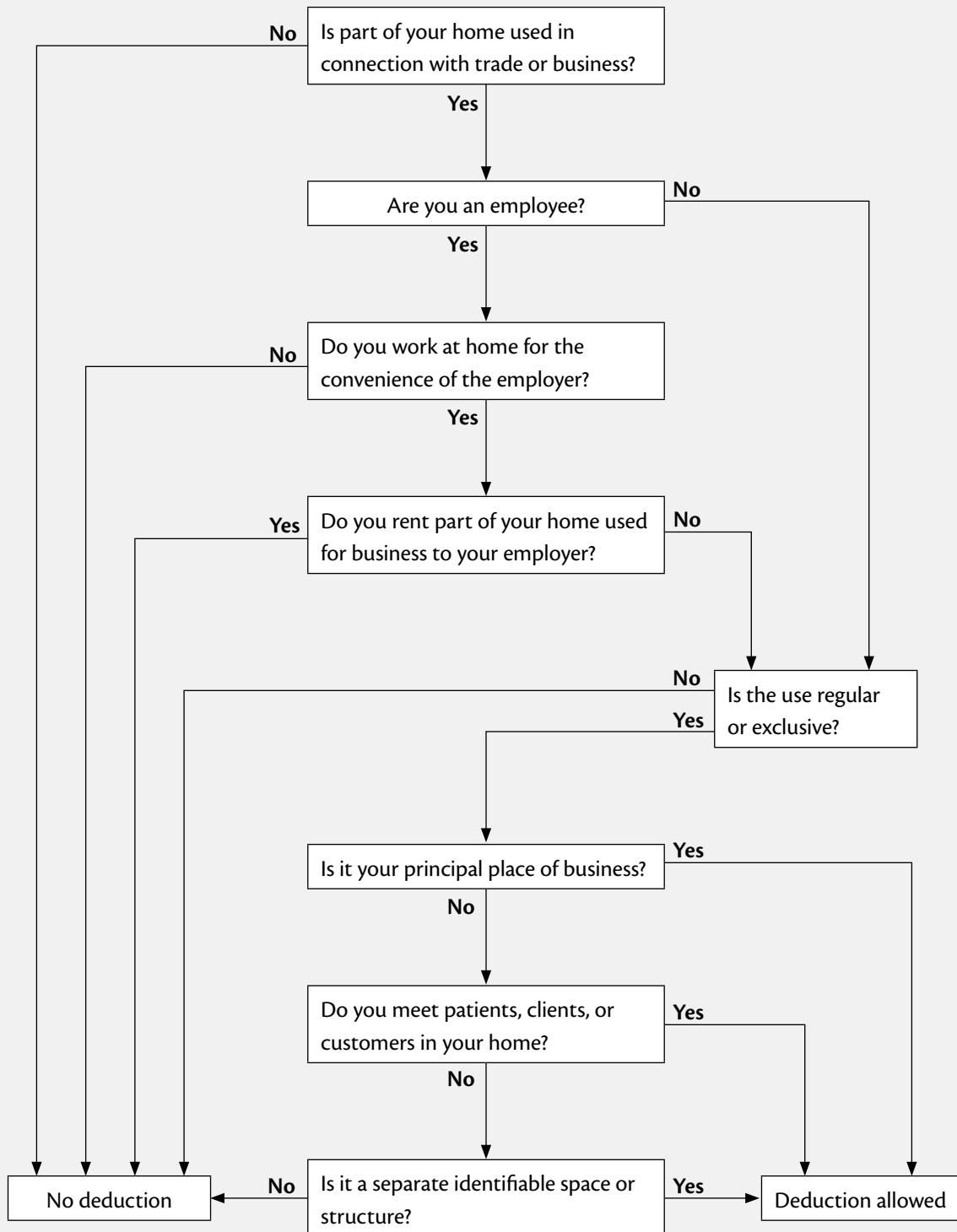
A house, apartment, condominium, mobile home, motor home, boat, or just about any other place with sleeping and cooking facilities can qualify for the home office deduction.

To claim a home office deduction (meaning you can deduct rent or depreciation), your home office must be:

- the principal place of your business
- a separately identifiable space in your home, and
- regularly and exclusively used for business.

All three of the rules must be satisfied, with two exceptions discussed below. (IRC § 280A.)

Can You Deduct Expenses for Business Use of the Home?



Rule 1. Principal Place of Business

Determining whether or not your home is the principal place of your business is not as simple as it sounds.

If your only job site is at home, it is your principal place of business. But what if you conduct business at a site outside your home and just bring work home sometimes? In that case, your home can still qualify as your principal place of business if both of the following are true:

- you conduct the administrative or management activities of your business there, and
- you have no other fixed location where you conduct those activities.

EXAMPLE: Jake, a plumber, works out of his home garage. Jake works at his home shop ten hours a week and in the field 40 hours. He gets a deduction for rent (or depreciation) and can deduct all other ordinary business expenses, such as the salary of his employee, as long as he meets Rules 2 and 3, below.

Your home doesn't have to be the place where you generate most of your business income. It's enough that you regularly use it for keeping your books, scheduling appointments, doing research, and ordering supplies. As long as you have no other fixed location where you do such things—for example, an outside office—you should claim the deduction. Service providers and salespersons who spend most of their time at other job sites but whose offices are at home should get the home office deduction.

EXAMPLE: Ellen, a wallpaper installer, performs services for clients in their homes and offices. She also has a home office that she uses regularly and exclusively to keep her books, arrange appointments, and store supplies. Ellen is entitled to the home office deduction.

Two other ways satisfy the principal place of business requirement: if you meet patients, clients, or customers at home or you use a separate structure on your property exclusively for business purposes.

Meeting clients or customers at home

If your home isn't your principal place of business, you may still be entitled to take a home office deduction if you regularly use part of your home to meet there with clients, customers, or patients. Doing so even one or two days a week is probably sufficient.

You can use the business space for other business purposes as well—phone calls and paperwork—but you'll lose the deduction if you use the space for personal purposes, such as watching Oprah.

EXAMPLE: Julie, an accountant, works three days a week in her downtown office and two days a week in her suburban home office. She meets clients at her home office at least once a week. Because Julie regularly meets clients at her home office, she can take a home office deduction. This is so even though her downtown office is her principal place of business.



TIP

Keep a log of the clients or customers you meet at home. Maintain an appointment book to record the name of the client or customer and the date and time of each meeting at your home. Save these books for at least three years to prove business usage if you're ever audited.

Using a separate building for your business

What if your home isn't your principal place of business and you don't meet clients or customers

there? You may still deduct expenses for a separate, freestanding structure that you use regularly and exclusively for your business. This could be a studio or a converted garage or barn.

EXAMPLE: Norm is a self-employed landscape architect. He has his main office in a professional center near a shopping mall, but he grows perennial seedlings in a greenhouse in his backyard. Because Norm uses the greenhouse regularly and exclusively for his landscape architect work, it qualifies for the home office deduction.

Be sure to use the structure only for your business. Don't store garden supplies there or even use it for the monthly meeting of your garden club.

Rule 2. Separately Identifiable Space

Assuming your home is the principal place of your business, let's move on to the second rule. The space in which you work must be separate from the rest of your home to qualify for the home office deduction.

A separate structure works best as proof of a legitimate home office to the IRS—for example, a detached garage converted to an office. But it's not necessary.

Many people convert a spare bedroom to a home office by removing the bed and personal items. Or, if your home office is not physically divided by walls, some kind of demarcation should be evident between the business and personal space. For instance, a desk and file cabinet set off in the corner of your living room will pass audit muster.

Rule 3. Regular and Exclusive Use

If you passed tests one and two, then let's go to the last test: regular business use. If you continuously meet business customers or do

paperwork at your home office, it satisfies the regular use test. Keep a calendar or diary of use or appointments, in case you're ever questioned by an IRS auditor.

Exclusive use means you can't use the space for any other purpose than business. This eliminates the kitchen table or the den where you watch TV with the kids. This rule is akin to Rule 2, separately identifiable space, above. An office should look like a pure work space.

Storing Inventory or Product Samples at Home

If you sell goods and you regularly store inventory or samples at home, you can deduct the storage space for the goods. There are two limitations, however. First, there's no deduction if you have an office or other business location away from your home. Second, you have to store the products in a particular place—your garage, for example, or a closet or bedroom. It's okay to use the storage space for other purposes as well, as long as you regularly use it for inventory or samples.

EXAMPLE: Jim sells heating and air conditioning filters to small businesses. His home is the only fixed location of his business. Jim regularly stores his inventory of filters in half of his basement. He sometimes uses the same area for working on his racing bikes. Jim can deduct an amount based on the square footage of the storage space even though he doesn't use that part of his basement exclusively for business.



TIP

Don't be afraid to claim a legitimate home office deduction. Claiming a home office depreciation or rent expense is no longer an IRS "red flag." A home office deduction is reported separately on IRS Form 8829, attached to your tax return, so it is easy for the IRS to spot.

Even if taking the deduction doubled your chances of audit, statistically, there's less than a one in 50 chance of an IRS confrontation. And, you'll lose the home office deduction only if you fail to follow the rules below. Before the audit, you will have plenty of time to make sure your home office appears office-like. Rarely will the auditor make a personal visit. Take some photographs of the home office to show the auditor.

Note: There is a tax drawback for depreciation recapture on sales of the home. (See "Tax When Selling The Home Office," below.)

Calculating Your Home Office Deduction

If you qualify for the home office deduction, calculate your deduction on IRS Form 8829, *Expenses for Business Use of Your Home*. If you don't want to do it by hand, tax prep software will walk you through the process, tally up the deduction, and create the right form for you. For a sole proprietor and independent contractor, Form 8829 is filed along with Schedule C on your individual tax return.

The first thing you will need to figure is how much of your home qualifies for the deduction. There are two methods to choose from in coming up with this number. One is based on the total square footage of your home and the other is on the number of rooms in your house.



CAUTION

Your home office deduction can't be more than your business's net income. The overall home office deduction cannot exceed the profit generated by your home-based business. For instance, if your business made a profit (after expenses) of \$2,700 before taking into account a home office deduction, your home office deduction can't be more than \$2,700. Tax prep software will check this for you.

The square footage method. First, divide the number of square feet used for your home business by your home's total square footage. The resulting percentage of business use (for instance, 27%) determines how much of your rent or depreciation is deductible each year. Other home-related expenses are deductible too (as discussed below).

Number of rooms method. The IRS also allows you to base the percentage of business use on the number of rooms in your dwelling. For example, one room used for business in an eight-room house produces a 12.5% deduction ratio. The size of the rooms should be about equal but don't have to be exactly the same.

(If you need more details, see IRS Publication 587, *Business Use of Your Home*.)



TIP

Run the numbers both ways. Try both methods, then choose the higher percentage figure using either the square footage or number of rooms calculation. (See examples below.)

You must prorate for partial years. If your business use of the home is for less than 12 months, you must prorate deductions to the nearest month. For instance, three months' business use means $\frac{3}{12}$ of the home office is deductible. See sample Form 8829, Part III, below.

Renters

For renters, the home office deduction is simple. Take the percentage of the space occupied for business and multiply it by your rent payments for the year or part year that you are in operation.

EXAMPLE: Lois, who makes and sells ceramic frogs at home, rents a three-room 900-square-foot cottage. The room that contains the kiln and working tables is 200 square feet. She pays \$9,000 rent per year. Using the number of rooms method, Lois is entitled to deduct

Sample Form 8829

Form 8829 Department of the Treasury Internal Revenue Service (99)	Expenses for Business Use of Your Home ▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year. ▶ See separate instructions.	OMB No. 1545-0074 20XX Attachment Sequence No. 176		
Name(s) of proprietor(s) John Stephens		Your social security number 465-00-0001		
Part I Part of Your Home Used for Business				
1 Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)		1 200		
2 Total area of home		2 2,000		
3 Divide line 1 by line 2. Enter the result as a percentage.		3 10 %		
For daycare facilities not used exclusively for business, go to line 4. All others go to line 7.				
4 Multiply days used for daycare during year by hours used per day		4 hr.		
5 Total hours available for use during the year (365 days x 24 hours) (see instructions)		5 8,760 hr.		
6 Divide line 4 by line 5. Enter the result as a decimal amount		6 .		
7 Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶		7 10 %		
Part II Figure Your Allowable Deduction				
8 Enter the amount from Schedule C, line 29, plus any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions		8 26,331		
See instructions for columns (a) and (b) before completing lines 9-21.				
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th style="width: 50%;">(a) Direct expenses</th> <th style="width: 50%;">(b) Indirect expenses</th> </tr> </table>	(a) Direct expenses	(b) Indirect expenses	
(a) Direct expenses	(b) Indirect expenses			
9 Casualty losses (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">9</td> <td style="width: 50%;">4,500</td> </tr> </table>	9	4,500	
9	4,500			
10 Deductible mortgage interest (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">10</td> <td style="width: 50%;">1,000</td> </tr> </table>	10	1,000	
10	1,000			
11 Real estate taxes (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">11</td> <td style="width: 50%;">5,500</td> </tr> </table>	11	5,500	
11	5,500			
12 Add lines 9, 10, and 11	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">12</td> <td style="width: 50%;">550</td> </tr> </table>	12	550	
12	550			
13 Multiply line 12, column (b) by line 7	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">13</td> <td style="width: 50%;">550</td> </tr> </table>	13	550	
13	550			
14 Add line 12, column (a) and line 13	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">14</td> <td style="width: 50%;">550</td> </tr> </table>	14	550	
14	550			
15 Subtract line 14 from line 8. If zero or less, enter -0-	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">15</td> <td style="width: 50%;">25,781</td> </tr> </table>	15	25,781	
15	25,781			
16 Excess mortgage interest (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">16</td> <td style="width: 50%;">400</td> </tr> </table>	16	400	
16	400			
17 Insurance	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">17</td> <td style="width: 50%;">400</td> </tr> </table>	17	400	
17	400			
18 Rent	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">18</td> <td style="width: 50%;">300 1,400</td> </tr> </table>	18	300 1,400	
18	300 1,400			
19 Repairs and maintenance	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">19</td> <td style="width: 50%;">1,800</td> </tr> </table>	19	1,800	
19	1,800			
20 Utilities	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">20</td> <td style="width: 50%;">300</td> </tr> </table>	20	300	
20	300			
21 Other expenses (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">21</td> <td style="width: 50%;">300</td> </tr> </table>	21	300	
21	300			
22 Add lines 16 through 21	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">22</td> <td style="width: 50%;">3,600</td> </tr> </table>	22	3,600	
22	3,600			
23 Multiply line 22, column (b) by line 7	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">23</td> <td style="width: 50%;">360</td> </tr> </table>	23	360	
23	360			
24 Carryover of operating expenses from 2009 Form 8829, line 42	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">24</td> <td style="width: 50%;">-0-</td> </tr> </table>	24	-0-	
24	-0-			
25 Add line 22 column (a), line 23, and line 24	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">25</td> <td style="width: 50%;">660</td> </tr> </table>	25	660	
25	660			
26 Allowable operating expenses. Enter the smaller of line 15 or line 25	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">26</td> <td style="width: 50%;">25,121</td> </tr> </table>	26	25,121	
26	25,121			
27 Limit on excess casualty losses and depreciation. Subtract line 26 from line 15	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">27</td> <td style="width: 50%;">252</td> </tr> </table>	27	252	
27	252			
28 Excess casualty losses (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">28</td> <td style="width: 50%;">252</td> </tr> </table>	28	252	
28	252			
29 Depreciation of your home from line 41 below	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">29</td> <td style="width: 50%;">252</td> </tr> </table>	29	252	
29	252			
30 Carryover of excess casualty losses and depreciation from 2009 Form 8829, line 43	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">30</td> <td style="width: 50%;">252</td> </tr> </table>	30	252	
30	252			
31 Add lines 28 through 30	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">31</td> <td style="width: 50%;">252</td> </tr> </table>	31	252	
31	252			
32 Allowable excess casualty losses and depreciation. Enter the smaller of line 27 or line 31	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">32</td> <td style="width: 50%;">252</td> </tr> </table>	32	252	
32	252			
33 Add lines 14, 26, and 32	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">33</td> <td style="width: 50%;">1,462</td> </tr> </table>	33	1,462	
33	1,462			
34 Casualty loss portion, if any, from lines 14 and 32. Carry amount to Form 4684 (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">34</td> <td style="width: 50%;">1,462</td> </tr> </table>	34	1,462	
34	1,462			
35 Allowable expenses for business use of your home. Subtract line 34 from line 33. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">35</td> <td style="width: 50%;">1,462</td> </tr> </table>	35	1,462	
35	1,462			
Part III Depreciation of Your Home				
36 Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">36</td> <td style="width: 50%;">75,000</td> </tr> </table>	36	75,000	
36	75,000			
37 Value of land included on line 36	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">37</td> <td style="width: 50%;">15,000</td> </tr> </table>	37	15,000	
37	15,000			
38 Basis of building. Subtract line 37 from line 36	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">38</td> <td style="width: 50%;">60,000</td> </tr> </table>	38	60,000	
38	60,000			
39 Business basis of building. Multiply line 38 by line 7	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">39</td> <td style="width: 50%;">6,000</td> </tr> </table>	39	6,000	
39	6,000			
40 Depreciation percentage (see instructions)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">40</td> <td style="width: 50%;">4.2 %</td> </tr> </table>	40	4.2 %	
40	4.2 %			
41 Depreciation allowable (see instructions). Multiply line 39 by line 40. Enter here and on line 29 above	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">41</td> <td style="width: 50%;">252</td> </tr> </table>	41	252	
41	252			
Part IV Carryover of Unallowed Expenses to 20XX				
42 Operating expenses. Subtract line 26 from line 25. If less than zero, enter -0-	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">42</td> <td style="width: 50%;">-0-</td> </tr> </table>	42	-0-	
42	-0-			
43 Excess casualty losses and depreciation. Subtract line 32 from line 31. If less than zero, enter -0-	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">43</td> <td style="width: 50%;">-0-</td> </tr> </table>	43	-0-	
43	-0-			
For Paperwork Reduction Act Notice, see your tax return instructions.				

one-third of her yearly rent—\$3,000—as a home office expense (assuming 12 months of business use). In addition, 33⅓% of her utility and renter's insurance expenses are also deductible business expenses. Lois must file Form 8829 with her tax return each year showing this allocation of expenses to her home business. Her rent expenses are claimed on line 18 of Form 8829 (see sample form above).

Owners

First, you must calculate the percentage of your home used for business. Then, you separate the value of the building from the value of the land it rests upon. This is necessary because you cannot deduct the cost of the land. (Land never depreciates in the eyes of the tax code.) You can use your local property tax assessor's breakdown, or you are probably safe allocating up to 80% of your property's value to structure and 20% to land. (See Example 1, below.)

Next, find the tax code depreciation rules in effect in the year you bought your home. (You can get this information at the IRS website, www.irs.gov.) For purchases after 1987, you must use straight-line depreciation. From 1987 to 1994, the period for taking the depreciation deduction was 31.5 years. Since 1995, the period has been increased to 39 years. This means for homes bought after 1995, you can deduct $\frac{1}{39}$ of the tax basis of the home every year, multiplied by the business use percentage. (See Chapter 3 for an explanation of depreciation rules and methods.) A tax preparation software like *TurboTax* makes this easier than it sounds.

EXAMPLE 1: Katie uses 22% (400 feet) of her five-room, 1,800-square-foot home for Katie's Krafts. Katie bought her home for \$100,000 in 2003 and started her business in 2004. The local property tax assessor says the lot

her home is on is worth \$20,000 and the structure \$80,000. (The \$20,000 land portion can't be taken as a depreciation deduction.)

Katie calculates her depreciation deduction by first dividing \$80,000 by 39 years. The result is \$2,051 per year, which is then multiplied by the business use square footage percentage, 22%. (This percentage is higher than the 20% figure she would have gotten using the "rooms" method.) That equals \$451—the amount of the home office depreciation deduction Katie can take each year she is in business.

EXAMPLE 2: Since she bought her home, Katie has made improvements costing \$20,000, so her basis for home office depreciation is increased from \$80,000 to \$100,000. This increases her home office depreciation deduction to \$564 per year ($\$100,000 \div 39 \text{ years} \times 22\%$).

Other Home-Related Deductible Expenses

Form 8829 requires that you separate all of your home-related business expenses into two categories: direct and indirect. Costs for the part of your home that is used exclusively for an office are a direct expense. Costs related to the entire home, such as your home's utility bill, are indirect home office expenses.

Direct expenses. Take a 100% tax deduction for anything spent just for the home office. Examples: costs of insuring equipment; decorating, modifying, or furnishing; or hiring maid service exclusively for your office portion.

Indirect expenses. Deduct a pro rata share of the utilities, repairs, taxes, and insurance expenses for all of your home as indirect home office expenses. Single-line telephone service to your home is not deductible, but a second phone line for business

Small-Time Online Businesses

Are you one of the army of eBayers or other folks selling things online? If so, you might have tax reporting duties.

Online sales, by auction or otherwise, fall within one of four possible tax reporting categories:

- **Nontaxable and not reportable.** If your online sale is like a garage or yard sale, you are off the hook. This means dumping old household goods and used personal items at less than what you paid for them. But, if you lose money on the sale, you don't get a tax benefit either.

EXAMPLE: After Oprah renounces fur as cruelty to animals, her big fan Lucy sells her \$20,000 sable coat on eBay for \$100. Lucy doesn't need to report anything to the IRS (and she can't claim a loss, either).

- **Online business profits are taxable.** Suppose you purchase items for resale online and your transactions are profitable overall. Congrats—you've become a business in the IRS's eyes. Unless you form a business entity, you are a sole proprietor and must file a Schedule C report with your tax return. Technically, if you lose money on the venture you don't need to report it to the IRS, but you won't get the tax benefit of any business loss either.

EXAMPLE: Regis buys broken BlackBerrys, refurbishes them, and sells them on Amazon.com. If he makes a profit at the end of the year, it is reportable (and income taxable). Regis is also responsible for the self-employment tax.

- **Assets sold online are taxable at either ordinary income or capital gains rates.** A lot of us own artworks, antiques, and collectibles, which we eventually sell for one reason or

another. If you are a collector who occasionally sells something for more than you paid for it, this is taxable at a rate of 28% if you hold the item for at least one year. If you hold it for less than a year, you'll be taxed at your ordinary income tax rate if it is 28% or higher.

EXAMPLE: Wilhelmina, an art collector, sells a Dali lithograph for \$2,500. She bought it 20 years ago for \$150. She has a capital gain of \$2,350 to report on her taxes.

- **Depreciated business assets sold online have tax consequences.** If you sell your business's assets online, you may have capital gains, ordinary income or losses, and/or depreciation recapture income to report.

EXAMPLE: Tyler uses Autotrader.com to sell a Toyota SUV he used in his delivery business for \$15,000. He originally paid \$32,000 for the vehicle and had claimed a total of \$20,000 in depreciation tax deductions in prior years. Tyler has taxable depreciation recapture of \$3,000 to report as income.

Online business expenses. Of course, you can deduct all of your online business expenses like any business expenses. This includes your cost of the items sold, auction fees, Internet access fees, shipping, envelopes and packaging materials, and so on. If you use your home computer exclusively for your online business, you can write that off too. Last but not least, you may qualify for the home office deduction for the part of your home you use for office space or storage space for your inventory.

State sales tax. Rules on online sales vary. Check with your state.

qualifies, as do any business long-distance charges. (IRC § 262(b).)

These indirect expense deductions are based on the same business use percentage of your home that you calculated earlier.

EXAMPLE: Katie, from the previous example, spent a total of \$2,110 for gas, electricity, and homeowner's insurance in one year. She also doled out \$820 to modify and repaint the office space. Tax result: Katie can write off 22% of the \$2,110 (\$464) for the indirect overall home expenses and all of the \$820 in direct home office expenses. With Katie's depreciation deduction of \$451, her total home office deduction is $\$464 + \$820 + \$451 = \$1,735$. To claim the deduction in full, Katie's home-based business must have made a profit of at least \$1,735 in that year.

Tax When Selling the Home Office

When you sell a residence on which you have taken depreciation deductions for a home office, you will be subject to a depreciation recapture tax. All of the depreciation deductions you took for business use of your home after May 6, 1997 are taxed (recaptured in tax lingo) when you sell your home. The fact that the law entitles homeowners to exclude \$250,000 (single) or \$500,000 (married) from the gain of the sale of their house doesn't avoid the recapture tax.

EXAMPLE: James took \$20,000 in home office depreciation deductions after May 6, 1997 and then sold his residence. The \$20,000 in previous deductions are now taxed to James in the year of the sale. James's tax bracket is 25%, so his recapture tax would be \$5,000 ($\$20,000 \times 25\%$), plus any state taxes, depending on where he resides.

Renters with home offices don't have this depreciation recapture problem, and don't have to pay back to the IRS any of their past rent deductions.

If you're moving to a new home office, your moving expenses may be partially or fully deductible (see Chapter 2).

A Home Business as a Tax Shelter

Hopefully, your home business will be a money maker. But even if it doesn't pan out, a loss may provide a tax shelter. This tantalizing term doesn't refer just to gold mining schemes, ostrich farms, or oil wells. A venture becomes a tax shelter simply by applying real or paper losses to offset your income from other sources, such as a regular job. There is no minimum amount of time or money you must invest in the business to qualify for this tax benefit, as long as you had a profit motive at the outset. Let's take a look at the rules.

IRS Audits of Net Business Losses

Historically, the odds against a small business being audited are about 50-to-1 in any year. However, tax returns with business losses—home-based or not—are audited most. The more years of losses, the more likely you'll be audited. The size of the loss is probably the biggest factor; a \$50,000 loss is more likely to blip on IRS radar than a \$5,000 one.

Business Losses at Home

A tax loss is not necessarily a cash loss. For instance, depreciation deductions for real estate are not out-of-pocket expenses but are often referred to as paper losses.

EXAMPLE: Carol, a clothing store manager who enjoys cooking, forms Carol's Catering as a home business sideline. Carol's big catering client declares bankruptcy, and Carol ends the year with a \$2,500 loss. Carol spent \$18,500 for food, supplies, and equipment and had revenues of \$16,000.

On her tax return, Carol claims a cash operating loss of \$2,500 plus \$2,200 for automobile depreciation expenses (a paper loss), giving her a total loss of \$4,700. This loss offsets wages from her regular job, trimming about \$1,500 off her income taxes.



CAUTION

Multi-level marketing losses may draw the attention of the IRS. We are all too familiar with Amway, Mary Kay, and the Avon lady. These can be legitimate home-based businesses with legitimate tax deductions. Be aware though that the IRS is on the lookout for sellers who buy products, claim a business expense, and then keep them for their own use. Of even greater concern to the IRS, however, are schemes that claim you can take business deductions for bringing others into the fold without ever selling a real product. A favorite IRS target here is deductions for auto and entertainment expenses for recruiting your so-called down-line. So, steer clear of these pyramid-type activities where the products are of questionable value.

Hobby or Business?

To deduct business losses, your business must look legitimate to the IRS. The tax law says a true business is “any activity engaged in to make a profit.”

To discourage people from claiming business losses from fun things like speedboat racing, the tax code prohibits claiming losses for “activities not engaged in for profit.” (IRC § 183.)

Hobby expenses can be deducted, but only up to the amount of income produced from

these activities. In other words, losses from a nonbusiness can't reduce your income from a real job. (This is called the hobby loss provision, but a truer description would be the no hobby loss rule.) Home business losses, on the other hand, can be used to offset income from another job and can be carried over to future years if the losses can't be used in the current year.

EXAMPLE: Carol, of Carol's Catering, is audited. The IRS auditor finds she was only indulging her cooking hobby, not running a business with a profit motive. Consequently, Carol's \$4,700 cash and paper losses in excess of revenues are disallowed—they can't offset her income from her regular job.

Whether Carol was engaged in a hobby or not depends on whether she can prove her business motive—that her goal was to make a profit.

The Profit Motive Requirement

You don't actually have to make a profit to be considered a business—you must only make an honest effort to do so. This so-called motive loophole invites imaginative people to claim tax losses for money-losing activities. The IRS looks at several factors to see if you have a profit motive.

The “3 of 5” test

One way the IRS determines whether a profit motive exists is by applying the so-called “three-of-five” test. If a venture makes money in three out of five consecutive years, it is legally presumed to have a profit motive. (IRC § 183(d).) The IRS relies heavily on this test when auditing small businesses that lose money.

Even if you flunk the three-of-five test, you can still claim business losses. It may just be a little harder. Courts have held that even an activity that never makes a profit can still be a business. The tax court upheld one long-suffering taxpayer

who claimed small business losses for 12 straight years! (*Lawrence Appley*, TC Memo 1979-433.) So don't give up taking losses on your tax return just because your enterprise doesn't pass the three-of-five test. As you'll see below, there are other ways you can show your profit motive.

EXAMPLE: Let's return to Carol and her struggling catering operation. This time, assume she keeps her business going, but at the end of her second year, she is still losing money. Carol has several tax options:

- She can throw in the towel, close her business, take tax losses in both years, and hope she isn't audited.
- She can continue to run her business and take any future losses on her return. If Carol does this, the likelihood of an audit goes up with every year that she reports a loss.
- She can close her catering business and go into a new sideline venture, which starts the three-of-five rule period over again.
- If the prospect of an audit keeps her awake at night, Carol can continue her catering business but stop claiming losses on future tax returns.

Filing Form 5213, *Election to Postpone Determination That Activity Is for Profit*, gives you an extra year to show a profit under the three-of-five test. For instance, say you lost money in the first three years of operation, but believe you'll turn the corner soon. Filing this form gives you a sixth year to overcome the presumption that your business is a hobby.



CAUTION

Form 5213 can draw unwanted IRS

attention. Few people ever file Form 5213, and for good reason. It may invite an audit.

If you really tried to make a profit—but can't convince an auditor—you can usually appeal or go to tax court. There is a good chance you'll get at least part of your claimed loss restored. Courts have allowed gentlemen farmers, stamp collectors, bowlers, garage-based inventors, and many other unsuccessful venturers to claim business loss deductions over IRS objections. (See Chapter 21.)

EXAMPLE: Gloria, an amateur artist, painted at home in her spare time and tried, mostly in vain, to sell her paintings. She lost money every year for many years, and was audited. Her business losses from painting were disallowed by the IRS for lack of a profit motive. The tax court heard Gloria's story and, finding that she had made a serious effort to sell her art, overruled the IRS. (*Gloria Churchman*, 68 TC 696.)

The three-of-five test is not the final word, even for perpetual money-losers. The IRS also must look at other factors to see if you have a profit motive, like how you conduct business, whether you have substantial income from other sources, and how pleasurable your business activity is.

Other ways to show profit motive

Another way to show a profit motive—and withstand an audit—is by demonstrating that you ran your venture in a businesslike manner. So be prepared to show an auditor:

- **Business records.** Bank statements, canceled checks, and receipts backing up your expenses.
- **Past success.** A previous history of making money in a similar business venture.
- **Advertising.** Flyers, business cards, stationery, ads, listings on the Internet, and anything promoting your business.
- **Your business diary or calendar.** Entries showing the names of people contacted for

business and any business use of your car or home. An entry might look like this:

3/1/2011

12:30 p.m. Met Don Skinner, buyer for
Bargain Basements, at Fabio's
Restaurant, Kalamazoo. Discussed sale
of 10,000 Tonya Harding T-shirts. Lunch:
\$27.42 with tip. Cab fare: \$12 round trip."

- **Licenses and permits.** State and local licenses, a fictitious business name registration, an occupational license, and a sales tax permit if required.
- **Education.** Special training, courses to develop expertise.
- **Financial need.** If the venture has potential to meet a personal financial need.

EXAMPLE: Carol worked at a restaurant as a teen and took cooking classes. She printed flyers for her catering service that she mailed to 2,000 local businesses, friends, and contacts, and she passed out business cards at social events. She kept track of her marketing efforts and business expenses in a spiral notebook. She also kept most receipts for her expenses, but never got around to getting a business license. Even though Carol did not do everything perfectly, this should be sufficient to establish a profit motive to an auditor or an appeals officer.



CAUTION

Try to look like a business. Be sure that an activity you enjoy—woodworking, bird breeding, or sewing, for example—appears businesslike. Inexpensive

indicia of profit efforts, such as business cards, stationery, and classified ads in local shoppers, can help persuade auditors that you're not just indulging in a hobby. As they say, "Walk the walk and talk the talk."

Home-Based Businesses in a Nutshell

- A business is any activity carried on with a profit motive, but it does not have to make a profit.
- The IRS may disallow small business losses if it finds you were actually indulging in a hobby.
- Many home-based business owners can deduct depreciation on part of their home or deduct part of their home rent.
- A home office must be a principal place of business, in a separate space, and regularly used for business.
- Home office expenses must be claimed on IRS Form 8829 filed with the individual's tax return.
- Expenses you incur for your at-home business are deductible even if you don't qualify for the home office deduction.
- Losses from a sideline business offset your other income, thus lowering your income tax bill.

Resources

- IRS Publication 505, *Tax Withholding and Estimated Tax*.
- IRS Publication 587, *Business Use of Your Home*.
- IRS Publication 946, *How to Depreciate Property*.
- *Home Business Tax Deductions*, by Stephen Fishman (Nolo).
- *Small-Time Operator*, by Bernard Kamoroff (Bell Springs). This CPA-authored book contains a wealth of information for very small businesses.

Fringe Benefits

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“A business that makes nothing but money is a poor business.”

—Henry Ford

Everyone has heard of fringe benefits, fringes, or perks, but what are they exactly? The term fringe benefit is mentioned—but never defined—in the tax code. Generally, fringes are things of value a business provides owners and employees over and above their wages and bonuses.

For business owners, fringe benefit expenses are almost always tax deductible as long as the rules are followed. For employees, fringes are usually, but not always, tax free. The tax code calls a tax-free benefit an “exclusion from income.”



SEE AN EXPERT

If you have questions on fringe benefits, see a tax pro. This chapter is only a summary of the rules on the most common fringe benefits. The rules are more complex than space permits in this book. You can also refer to IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.

How Fringe Benefits Save Taxes

Taxwise, a fringe benefit for a recipient may be any of the following:

- **Totally tax free**—the best way to go. For example, the costs of a medical plan provided by a business to its employees is totally excluded from the employees' taxable income.
- **Partly tax free**—second best form of a fringe. For example, a company car used by an employee while off-duty is partially excluded from the employee's taxable income.
- **Tax deferred**—that is, not taxed until later. For example, a stock option given to a

corporate employee. It is not counted in the employee's income until the stock is sold.

- **Fully taxable**—but still a good deal. For example, the cost of a group life insurance policy provided by a business is included in the employee's income, but the cost is less than the employee could otherwise find for insurance.



CAUTION

Follow the rules on benefit plans or risk the consequences. The IRS can audit fringe benefit plans separately or as part of a regular examination. If plans are not in compliance with all aspects of the tax law, then previous tax deductions or contributions to the plans can be disallowed. The business loses the deductions, and the benefit recipients will have to pay taxes on the benefits—an all-around disaster.

A fringe benefit is excluded from an owner or employee's income only if Congress specifically grants it fringe status in the tax code. Most fringe benefits are found in Sections 101 to 137 of the Internal Revenue Code. Certain fringes must be set forth in formal writings, such as a 401(k) retirement plan offered by a business. And certain fringes must have an indefinite life.

For the most part, fringe benefits are not subject to Social Security, Medicare, and Unemployment (FUTA) taxes—although a few are.

This chapter discusses the most popular benefits for small business owners and employees, including retirement plans and health insurance; business vehicles, meals, and travel; and education and day care benefits. A few fringes are available only to C corporations. However, the decision to incorporate should rarely be made based on the availability of fringe benefits alone. Very few businesses can afford the full range of corporate-type fringe benefits.

Retirement Benefits

Dollarwise, the most valuable fringe benefit is—by far—a tax advantaged retirement plan. Business owners and employees can deduct and put away money in retirement funds to accumulate tax free for many years. Until withdrawn, the funds are invested, and any income produced is not taxed. Retirement plans are available to all types of business owners and most employees. Chapter 16 is devoted entirely to the fringe benefit of retirement plans.

Motor Vehicles

Autos are the average American's third largest expense, after housing and food. Happily, the tax code helps share the cost when the vehicle is used for both business and pleasure—often the case with a small business. This big dollar fringe is covered in Chapters 2 and 3.

Meals

If a business pays for meals of owners and employees, the cost is usually partly tax deductible to the business and a tax-free fringe for the diners. The meals must serve a business purpose and be provided in the course of employment as explained below. (IRC § 119.) (Note that meals taken while traveling or as entertainment are treated differently.)

Here are the basics:

- **Meals provided on site.** Meals and drinks are 100% deductible to the business and tax free to the employee if given for the convenience of the employer. This fringe doesn't cover every day lunches. Instead, it is limited to people who work late or through the normal meal hour, employees of restaurants and catering businesses, and situations where the

meal periods are too short for workers to find a suitable meal off the premises.

EXAMPLE: Reggie, the owner of Wonderful Windows, a wholesale drapery business, occasionally orders pizza for employees working late to finish a custom order. This expense is for the convenience of the employer so it's full deductible for the business and tax free to the employees, even if Reggie has a slice or two.

Snacks, like coffee and doughnuts, can be provided to workers for free and deducted by the business. Also, meal money given to employees is tax free as long as it is only done occasionally and there is a clear business purpose. These items come under a different fringe rule as "de minimus" benefits, discussed later in the chapter.

- **On site kitchen.** Meals—but not free food—can be provided to employees from a company cafeteria or dining room. Prices employees pay must cover the company's direct food costs. These subsidized meals are a fringe for employees, and tax deductible to the business.
- **Meals provided off premises.** Food and drink for owners and employee meetings off the business site may be deductible and tax free if done only occasionally and business is discussed. However, the 50% deductible limit applies.

EXAMPLE: Reggie takes her sales manager and a top salesperson out to dinner once a month. They discuss plans for future promotions. The bill comes to \$100. The meal is a tax free perk for the employees but the tab is only 50% deductible for Wonderful Windows, the business.

Travel and Lodging

Most of us like to go out of town occasionally, even if it's for work. If the trip is primarily for business, your enterprise can deduct the costs—even if you do some sightseeing or visit friends along the way. A business owner can deduct 100% of the reasonable costs of public transportation (like airfare) and lodging. The business trip must require travel far enough away from home to require overnight rest to deduct the hotel expense.

But your business can deduct only 50% of your meal costs while you're on the road. It's not 100%, because you would have presumably had some meal costs if you had stayed home (and home-cooked dinners aren't deductible). (IRC § 132.)

The IRS allows you to keep frequent flyer miles you earn on business travel and credit cards, unless you convert your miles to cash or merchandise.

Note that this discussion doesn't cover business trips in your vehicle. For those rules, see Chapters 2 and 3.

Mixing Business and Pleasure Travel

An out and out vacation trip for business owners is never deductible. And while a business can pay for and deduct the expenses of an employee's vacation, that amount must be shown as additional income for the employee.

With some planning, a business can pay for—and deduct—a large portion of your vacation expenses without having the cost added to your income. Have you noticed that conventions and trade shows are often held in resorts and destinations like Orlando and Las Vegas?

To be tax deductible and not count as income to the traveler, the trip's primary purpose must be business. Travel for political, investment, or social conventions cannot be deducted as a business expense. Business, however, doesn't have to be the sole purpose—if you have some fun on the side,

it's okay with those junketeers in Congress who write the tax laws.

How do you prove your trip had a clear business purpose? Obvious cases—a car dealer going to Detroit to meet with factory representatives or a bookstore owner traveling to a booksellers' trade show—shouldn't be questioned by an IRS auditor. On the other hand, Joe the Plumber going to Hawaii to study pipe insulation will not likely pass an IRS auditor's "laugh test."

There are few hard-and-fast rules: If you use your common sense and don't push too far, your mixed-purpose travel should pass tax muster.

Business Meetings, Trade Shows, and Conventions

There are some special tax code rules for business meetings, trade shows, and conventions:

- **In the United States.** If you travel to a business event within the United States, your expenses are deductible to the business. There's no problem as long as you go straight there and come back as soon as the event is over. If you don't, any expenses for the extra time you spend there won't be tax deductible.
- **Canada, Mexico, Puerto Rico, or the Caribbean.** Business travel costs for meetings in Canada, Mexico, Puerto Rico, or most of the Caribbean are also deductible, provided you stay away no longer than seven days and spend at least 75% of your time on business. If not, you must allocate the expenses between business and pleasure. Keep a log of how you spend your time in case you're ever audited.
- **Outside North America and the Caribbean.** Travel outside North America and the Caribbean is deductible only if you can show a valid business necessity for the trip—it was something you could not accomplish in the United States. Researching organic fruit

processing in Paraguay for your frozen food operation sounds okay, but studying high technology there doesn't.

- **On cruise ships.** If you take a seminar on a cruise ship, the whole trip will be tax free and deductible as long as:
 - there is a bona fide program on board related to your business
 - the majority of the days are spent in program attendance
 - the ship is registered in the United States.
 - the ship stops only at U.S. ports (or U.S. possessions), and
 - the trip costs less than \$2,000.

However, because of federal laws and union rules, few cruise ships are registered in the United States. Generally, only companies operating in Hawaii and on the Mississippi River qualify. For details, see IRS Publication 463.

Temporary Assignment Relocations

Business may take you away from home for up to one year with company-paid (or reimbursed) travel and living expenses. While there is no limit on how much your business can pay and deduct, it must be reasonable under the circumstances. After the first year, living expenses paid by your company are income to you—but are still tax deductible as compensation by the business. (IRC § 162, Rev. Rule. 93-86.)



TIP

Weekend and holiday stayovers are deductible if you fly. Some airlines require a weekend stayover for the lowest fare, or charge premium fares for holiday periods. So, if the total costs of air, weekend hotel, and meals on a business trip are less than the cost of air without a holiday fare or Saturday night, you

can come back home a few days later and enjoy a tax deductible mini-vacation in a new town. Get an airfare cost comparison online at the airline's website and keep it for your records in case you ever get audited.

Taking the Family Along

Family travel combined with a business trip can be partly deductible. The primary purpose of the trip must be for business. What will pass IRS review is any business expense that you would have incurred while travelling alone. For example, vehicle expenses are fully deductible even if you have extra passengers along. The same with hotels; if your family stays in one standard room with you, the entire cost is tax deductible.

EXAMPLE: Zeppo, owner of Zowie, an electronic parts retailer, his wife, Zookie, and their two kids fly to Anaheim, California, so Zeppo can attend a three-day electronics trade show. While Zeppo is at the show, the rest of the family heads for Disneyland. Everything is deductible except the air tickets for his wife and kids, their meals, and the cost of park admissions. If Zeppo had driven his car, then all the transportation would have been deductible too. If the family lingers around for another week, however, the postbusiness expenses won't be deductible.

In the past, a spouse's travel expenses could be deducted if his or her presence served a business purpose. Now, only a spouse who is a bona fide employee or co-owner of the business can have his or her expenses paid and deducted.



TIP

Make a paper trail. Business travel to Maui or other obvious resort destinations will raise the eyebrow of an IRS auditor. Keep a copy of the convention program or trade show schedule along with all your receipts in case the IRS asks any questions later.

We recommend keeping all business deduction records at least three years after you file your tax return or, to be even safer from IRS questioning, six years.

Lodging at the Workplace

Owners and employees of businesses such as motels, emergency services, and funeral homes, where someone must be on call 24 hours a day, get a special tax break. The business can deduct all the housing costs and the resident owner or employee doesn't incur any taxable income from the arrangement.

The business can also deduct the costs of the resident's meals eaten on the premises. To qualify, three conditions must be met:

1. Living on the premises must be an express condition of employment (so put it in writing).
2. It must be primarily for the convenience of the employer.
3. There must be a legitimate need for someone to be at the business around the clock. (IRC § 119.)

Clubs and Athletic Facilities

A business can provide owners and employees with a limited amount of tax-free socializing and entertainment at clubs and athletic facilities. (IRC §§ 132, 274; Reg. 1.132, 1.274.) There are some very specific restrictions that apply. Here are the rules:

- **Civic associations.** Dues for civic associations—chambers of commerce, real estate boards, business leagues, and public service clubs like Rotary and Lions—are tax deductible and tax-free fringes.
- **Social clubs.** Dues for purely social clubs, like country clubs and golf and athletic clubs, are not deductible or tax-free benefits—even if the club is used primarily for business. (Reg. 1.274-2.) But while club memberships

are not deductible, 50% of business entertainment expenses incurred there—such as greens fees and client entertainment expenses—are deductible and tax-free fringes.

- **Athletic facilities.** Paying employee dues for off-premise athletic clubs is not deductible. But owners can provide athletic facilities on or off the business's premises and deduct the cost (as long as they are open to all employees, their spouses, and dependent children). This can be anything from a NordicTrack in an unused storeroom to a full company gym with a swimming pool. It's a nontaxable fringe for the employees.

Health Benefits

The tax law encourages businesses to offer health care plans by allowing deductions and credits for their cost. This perk just got more affordable for small businesses with a new tax credit starting in 2010. Tax rules about health plans can vary depending on the type of business entity involved and the number of employees. In general, financially sound C corporations can offer the greatest range of health benefits.

Deducting Health Insurance for Employees

Any business can deduct health insurance costs that it pays on behalf of employees as a business expense. Any type of business entity—C corporations, solo proprietors, partnerships, LLCs, or S corporations—can take this deduction as long as the expense is for employees' (not owners') health insurance costs. The business claims the insurance expense on its business tax return (for example, Schedule C for solos). (See IRC Section 162.) And it is a tax-free fringe for the employee.

Health insurance payments made on behalf of an owner cannot be deducted as a business

expense. Instead, these costs can be deducted by the owner as a personal deduction (see “Solos, Partnerships, LLCs, and S Corporations,” below and Chapter 3).

Health Insurance Tax Credit

Starting in 2010, small businesses that offer health insurance benefits may be able to take advantage of a very generous new tax credit. Businesses that pay at least half the cost of coverage for their employees or their employees and their families can get up to 35% of the health insurance premiums paid as a tax credit. The credit is scheduled to go up in future years. To be eligible, the business must have fewer than 25 full-time employees who earn wages averaging less than \$50,000.

The amount of the credit is scheduled to go up in future years. Tax credits are always more valuable than tax deductions as they are dollar for dollar reductions in taxes owed by the business. The business can also deduct the cost of providing health benefits but the deduction must be reduced by the amount of the credit claimed. You use IRS Form 8941 to claim the credit.

EXAMPLE: East Shore Motorcycles has a total of ten part- and full time employees. This includes salespeople, office workers, and mechanics. The total wages paid to all employees for 2011 was \$250,000. The company spends \$70,000 to pay for medical insurance coverage for its employees. East Shore gets a tax credit of \$24,500 (35% of \$70,000) and a tax deduction of \$44,500 (the balance of the cost of the medical insurance it paid).

Medical Savings Accounts

A small business with 50 employees or fewer can offer its employees an Archer Medical Savings Account (MSA). This benefit can be in addition to health insurance coverage provided by the employer. An MSA is similar to an IRA where employees or the business put money into an account at a financial institution. The funds are invested and earn a tax-free return and can be withdrawn by the employee to pay for medical costs not covered by insurance. In addition, employees can deduct up to 65% (individual) or 75% (family) of their MSA plan contributions each year. A business contributing to a plan for its employees can deduct 100% of its contributions. Nothing is taxed as income to the employees.

To qualify for an MSA, the business must first purchase health insurance that has a deductible of at least \$2,000 for individuals or \$4,000 per family (2009). The MSA rules are complex. For more details, see IRS Publication 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

Flexible Spending Accounts

Any small business can set up a Flexible Spending Account (FSA) for individual employees' medical expenses. The employees (not the business) can contribute part of their wages to the FSA. The minimum contribution, usually from a payroll deduction, is \$240 per year, and the maximum is \$3,600 (2011 limits). The money can be used by employees throughout the year for their family's co-pays and prescription (only) drugs and certain other medical expenses (see IRS Publication 502). All of the funds in the employee's account must be used to pay medical expenses no later than 2½ months after the end of the calendar year or they are forfeited. (IRC § 125.) This rather small tax

benefit helps employees pay medical expenses with pretax dollars and businesses save a little on their share of the payroll taxes.

Group Plans Paid by Employees

Any small business can establish a group health plan with premiums paid partially or wholly by the employees, typically through payroll deductions. Monies paid out of the plan for medical bills are tax free to the employees.

Solos, Partnerships, LLCs, and S Corporations

Owners can deduct 100% of health insurance premium costs for themselves, their spouses, and their dependents as a personal income tax deduction. This deduction is available to sole proprietors, partners, limited liability company members, and S corporation shareholders active in a business. Owners use this deduction for their health insurance costs instead of the business expense deduction that C corporations and owner entities use for employees. The deduction is reported by the owner on the first page of his or her personal (Form 1040) tax return.

No insurance deduction is allowed for people who could be insured through another job or their spouse's work but have chosen not to be. The IRS can't spot this issue by looking at a tax return so it would have to be discovered by an IRS auditor.

In addition, medical expenses not covered by insurance can be claimed as a personal itemized deduction on an individual's personal tax return. One catch with this deduction is that the total of all out-of-pocket medical costs must exceed 7.5% of the individual's (or married couple's) adjusted gross income. This 7.5% floor effectively eliminates uninsured medical deductions for mid- to higher-income individuals or those without

unusually high medical expenses. Tax preparation software can make these calculations for you.

C Corporations

In addition to the medical benefits available to any type of business discussed above, C corporations can provide a few more perks to their employees. Remember that owners/shareholders of C corporations are also employees so they can take advantage of employee corporate perks and fringes. (Non-health fringes that only C corporations can offer are covered below in "Special Benefits for C Corporation Employees Only.")

Medical Reimbursement Plans

A C corporation can establish a medical reimbursement plan to pay or reimburse an employee for medical expenses not covered by insurance. The cost is fully deductible for the business and a tax-free benefit for the employee. This is better than someone simply claiming a personal medical expense deduction because you can only deduct medical expenses (other than insurance premiums) to the extent they exceed 7.5% of your adjusted gross income. This rule effectively eliminates medical deductions for highly compensated individuals, unless they have very high medical expenses. A C corporation can get around this restriction with this type of corporate medical plan.

To get this benefit, the C corporation must establish a written medical reimbursement plan under tax code rules. (See IRC 105(h) and Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.) The plan must cover at least 70% of all employees, with some exceptions. Because of these and other rules, only C corporations with very few or no employees (other than the owners, spouses, and dependents) offer this benefit. Be sure to check with a tax pro before adopting one of these

plans to make sure you are following the latest tax rules.

EXAMPLE: Sitcom Writers Inc., a C corporation, adopts a medical reimbursement plan. Fred and Ethel are the sole stockholders and employees in the corporation. Ethel has an operation on her funny bone that costs \$95,000. Her insurance pays \$75,000 which means she still owes \$20,000 for the surgery. Sitcom Writers Inc. can either pay \$20,000 directly to the hospital or it can reimburse Ethel for the cost. Either way, the \$20,000 is tax free to Ethel and a deductible expense for the business.

Disability and sick pay

Insurance premiums can be paid and deducted by a C corporation for an employee's disability, including wage continuation, illness, and accidents. However, disability or sick pay is taxable to the employee. There is an exception to the taxability rule in certain cases of permanent or total disability. For details see IRC §§ 104, 105.

Annual checkups

Even if your corporation doesn't have a health plan, the cost of physical checkups by an employee's doctor can be paid and deducted by the business. To qualify, there should be a written employment contract between the corporation and employee stating that annual checkups are a condition of employment. This fringe is tax free even if the exams are only required for top executives. (IRC § 162.)

Dependent Care Benefits

Any business can deduct the cost of a dependent or day care assistance plan offered to employees for the care of children under the age of 13.

Payments related to these costs of up to \$5,000 per worker annually are tax free to the parents if they file a joint tax return. Otherwise, it's only \$2,500. The business can deduct all payments to workers, even if they exceed \$5,000. (IRC § 129.) But any excess is taxable to the parents.

This benefit must be given to every parent on the payroll, except that the corporation may exclude:

- employees under age 21
- those with less than one year of service
- employees covered by a collective bargaining agreement (IRC § 129), or
- highly competitive employees (IRC 129(d)).

Employees not covered by a dependent care plan may still qualify for the dependent care income tax credit. For details, see IRC § 21.

An employer who provides on-site child care may qualify for a general business tax credit. See IRC § 45F for details and "The General Business Credit" in Chapter 2 for more information.

Long-Term Care

All businesses can provide a tax deductible and tax-free benefit for long-term health care insurance coverage. There is a daily limit of \$290 (2010) for a nursing home type facility. The cost for any coverage over that amount is taxable income for the employee. The rules are fairly complex, so see a tax pro or IRS Publication 502, *Medical and Dental Expenses*, for details.

Group Term Life Insurance

Businesses can provide up to \$50,000 in group term life insurance to employees (and former employees) tax free. (IRC § 79.) However, your business must have at least ten employees covered by the insurance to qualify. Individual policies aren't allowed under this provision. The cost of any coverage over \$50,000 is still deductible but

is taxable income to the employee. The coverage must include all full-time employees and the plan can't require physical exams. See IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, for more information.

A business also can provide tax-free group life insurance for an employee's spouse and dependents—but the benefit can't be more than \$2,000 for each person covered.

While not an employee benefit, a business can provide so-called “key person” insurance coverage on its employees, and deduct the costs of the coverage. For details, see IRC § 101.

Education Benefits

Businesses can get a big tax deduction by helping owners and employees get educated. School tuition, fees, books, and supplies—as well as travel to and from classes—can be offered as a tax-free benefit. There are three sets of tax rules and restrictions.

Directly-Related Education

Training for an owner or employee to improve job skills is a fully deductible and tax-free benefit. The business can either pay the costs or reimburse the student. To qualify for the tax benefits, the education must be *directly related* to the job. This is called a “working condition” fringe benefit under the tax law. See IRC § 132.

The benefit isn't tax free if it is to qualify the student for a new line of work (not directly related to his or her present job) or if it's to meet minimum education requirements for a person's existing job. And, while there are no dollar limits on education benefits under the tax code, the costs must be reasonable considering the business's financial circumstances. This vague language often creates a gray area.

EXAMPLE: The Super Fast Food Drive-Through sends Rachel, its fry cook, to a food preparation class at the local community college. The deduction and benefit appears to be directly related to the business and reasonable. But sending Rachel to the Cordon Bleu academy in Paris would likely not qualify as “directly related” or reasonable to an IRS auditor.

Education Assistance Plan

A business can deduct the costs of an employee's education even if it's not job related, as long as the enterprise has an Educational Assistance Plan (EAP), also known as a Tuition Assistance Plan. (See IRC § 127.) To be a tax-free fringe, the following requirements must be met:

- the plan must be in writing
- the benefits must be offered to all employees
- payments must be made directly to the institution or reimbursed to the employee
- only tuition, books, supplies, and related items may be provided under the plan
- benefits can't exceed \$5,250 per year (any excess is taxable income to the employee)
- the courses must be for traditional education and not for sports, hobbies, or games.

Other Education

A business that pays for an employee's education (other than “directly related” or under an Education Assistance Plan) can still deduct those expenses but the cost is not tax free to the recipient. And there are other non-business-related tax breaks for education available to all taxpayers, including the Coverdell Education Savings Account and the American Opportunity Credit and Lifetime Learning Credit. See IRS Publication 970, *Tax Benefits for Education*, and Chapter 16 for more information.

Dues and Subscriptions

Business owners can pay and deduct trade association dues for themselves and their employees. Subscriptions to online or business publications are also deductible. The organization cannot, however, be primarily social in nature. (IRC § 162; Reg. 1.162-6, 1.162-15.)

EXAMPLE: Jessica, owner of Wheelies Bikes, a bicycle parts store, pays \$300 per year for membership for her and her employee, Meryl, in the National Bicycle Foundation. They both go to its annual meeting. This is a deductible business expense for Wheelies and is a tax-free perk for Meryl.

Driver and Bodyguard Services

If there is a legitimate concern for the safety of a business's owner or employees, a bodyguard or driver is a deductible business expense and a tax-free benefit. High profile executives and entertainers or ordinary folks working in dangerous neighborhoods will qualify. But be prepared to prove the necessity of these expenses if you are questioned at an audit.

Moving Expenses

Employees' expenses for a job-related move of their residence can be paid for or reimbursed tax free by the business. Owners can also deduct the costs of their move, but as a personal, not business, expense (see Chapter 2). Generally, the move must be at least 50 miles away from the old job site, and not all moves qualify. See IRS Publication 521, *Moving Expenses*, for more information.

Retirement Planning Services

Outside professional advice can be offered as a benefit to employees for their financial retirement planning. This deductible and tax-free benefit does not extend to services for tax preparation, brokerage, accounting, and legal fees. See IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, and Chapter 16 for more details on tax-favored retirement accounts.

Gifts, Awards, Discounts, and Free Services

The cost of goods and services can be given tax free to employees only if they fit into one of the following categories.

Small Gifts to Employees

Gifts totaling under \$25 per year per employee are nontaxable. (IRC § 132.) So, the proverbial Thanksgiving turkey gift for employees is tax free to them and deductible to you. This \$25 limit applies to all business entities. However, a holiday gift payment or gift certificate in any amount is taxable to the recipient.

Employee Awards

A business can deduct the costs of an award to an employee and it will be tax free to the employee if it falls within one of three categories. Here's a summary—for more details see IRS Publication 535, *Business Expenses*.

Achievement. Awards are tax free when given to an employee for length of service or safety achievement. The award must be an item of tangible personal property that is awarded as part of a meaningful presentation under conditions that do not create a significant likelihood of disguised pay.

Length-of-service. A long-time employee can get an award after his or her first five years of employment, as long as that employee did not get a similar award (other than one of very small value) during that year or in any of the prior four years.

Safety. An award for safety is tax free unless it is given to a manager, administrator, clerical employee, or other professional employee. In addition, more than 10% of all employees (excluding those listed above) cannot receive a safety achievement award during the same year (other than one of very small value).

A business's deduction for the cost of employee awards is limited to \$400 per employee each tax year or \$1,600 for all employee awards whether or not they are made under a qualified plan. A qualified plan award is one that is done pursuant to a written qualified plan that does not favor highly compensated employees as to eligibility or benefits. A highly compensated employee is defined as either a 5% owner or someone who received more than \$110,000 in pay for the preceding year.

No Added Cost Services

Certain businesses—such as hotels, airlines, and cruise lines—can provide free usage of their services or facilities to employees, former employees, and their families.

This applies only to “excess capacity” services—something that would likely remain unused if not given away, such as empty airplane seats and hotel rooms, but not much else. Reciprocal agreements to provide this type of service from an unrelated employer are allowed, too.

The free services must be available to all employees, not just management and executives.

Discounts

Discounts on your business's goods or services may be given to employees and owners tax free. You can provide anything your business makes or sells at a reduced price, but never below the gross profit percentage based on the price paid by regular customers or your actual cost.

EXAMPLE: Honolulu Hot Tubs (“HHT”) sells a hot tub valued at \$3,000 to Hana, a salesperson, for \$1,800, its cost. This is the invoice cost for HHT so it is tax free to Hana. Had she paid only \$1,500 for it, HHT would have to report \$300 of income to Hana.

Services may be provided at a discount of up to 20%. For example, a dentist filling a cavity must charge at least 80% of his or her going rate or report the excess discount as income to the recipient.

Discounts must be given across the board to all employees, not just to higher-paid people.

There are a few items specifically prohibited from being discounted without being taxed to employees—like real estate and investment property. (IRC § 132.)

Commuter Transportation and Parking

Any business can provide parking money or transit passes for employees. Up to \$230 per month (2011) is deductible to the business and tax free to the employee.

For reimbursements, the employee must give substantiation—receipts—showing the amounts paid. (IRC § 132.)

Van pool. A business can offer and deduct the costs of a van commute to employees tax free, as long as the vehicle seats at least six besides the driver and at least 80% of the mileage driven is for employee commuting.

Bicycles. Bike commuters may be reimbursed by the business, tax free, including the cost of their wheels plus modifications, repairs, and storage. See IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, for details.

Working Condition Fringes

Goods and services given to employees to perform their job are termed “working condition” benefits and are tax free. Some have been discussed above. The tax code indirectly defines working condition expenses as items that an employee could have deducted as a business expense or depreciation expense if he or she had paid for it. For example, the use of a company car or job-related education expenses. This exclusion also applies to cash reimbursements for an employee's expenses. The business must require the employee to substantiate that the payments were made with documentation such as receipts. For details, see IRS Publication 529, *Miscellaneous Deductions*.

De Minimis Benefits

Businesses can deduct and provide so called de minimis benefits tax free. This covers anything that has so little value that accounting for it would be unreasonable or administratively impracticable. However, cash or equivalents (for example, a gift card), no matter how little, generally don't qualify. Examples of de minimis benefits include occasional personal use of a company copying machine, holiday gifts with a low value, parties for employees, and occasional tickets for theater or sporting events. See IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, for details.



CAUTION

Look out for taxable fringes. More valuable perks—season tickets to sporting events, the use of

an employer-owned vacation facility, or a company car used for commuting—are taxable income to the recipient. The fair market value or cost of these benefits must be shown on an employee's end-of-year W-2 form along with wages. The expense is still deductible to the business, however. IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, explains how to withhold, deposit, and report taxes on fringes.

Adoption Assistance

A business can pay directly, or reimburse an employee for, qualified adoption expenses up to \$13,170. Qualified expenses are those that are necessary for the adoption itself, such as attorney's fees, court fees, and adoption agency fees. See IRS Publication 9688, *Tax Benefits for Adoption*, for more rules including limitations for high earners.

Job Placement Assistance

Helping departing or former employees find new jobs is a tax-free benefit and deductible for a business. Assistance must be provided to all employees, and the former employees can't be offered the choice of job placement services or cash. (IRC § 132(d).)

Cafeteria Plans

A business can offer a range of the type of benefits discussed above in a so-called “cafeteria plan.” This is a written plan that allows employees, under specific circumstances, to choose between receiving cash or taxable benefits instead of certain tax-free benefits. The rules for setting up a cafeteria plan are too complex for most small businesses, but if this looks interesting, see a tax pro or IRC Section 125 and IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, for details.

Special Benefits for C Corporation Employees Only

Most of the fringe benefits discussed so far apply to all business structures. But C corporations get a few more tax breaks for providing certain fringe benefits. Keep in mind that owners/shareholders of C corporations who work in the business are employees so they can get these perks, too.

Loans to Shareholders

Shareholders may borrow money from their financially solvent C corporation ventures. One fringe benefit is that loans of up to \$10,000 to shareholders may be made interest free. No other business entity can make an interest-free loan. Loans over \$10,000 require the shareholder to either pay interest to the corporation or be taxed on the legal minimum interest that should have been paid. The loan always must be backed up by a promissory note, and noted in the records of the corporation. The minimum required interest rate is set by the IRS and changes periodically. (See IRC § 7872.)



CAUTION

Observe loan formalities. “Loans to Shareholders” in Chapter 8 covers shareholder loan rules. For example, your corporate records must show the loan was authorized, and there must be a written promissory note to the corporation. Otherwise, an IRS auditor may rule that the shareholder loan is really a disguised dividend, wages, or bonus, making it taxable income to the borrower.

Entertainment and Vacation Facilities

Corporations can’t deduct the cost of facilities used purely for the entertainment of owners and employees: ski cabins, yachts, hunting lodges,

and so forth. (IRC § 274(a).) Facility operating costs are deductible for the periods used solely for business, however. This requires records of time spent for corporate business like shareholder meetings, entertaining customers and clients, or marketing and sales planning sessions for employees. (IRC § 274(a).)

The value of vacation stays in business-owned properties is taxable income to owners and employees (unless there is a business purpose). A business can provide favorable rental rates to owners and employees, though.

As an alternative, a corporate shareholder who owns an entertainment facility can rent it to his or her C corporation. This will pass muster with the IRS as long as the rent is reasonable and the property is also available for rent to the public. The corporation may even lend the shareholder the money to buy the facility. The shareholder gets the tax write-offs for interest, depreciation, and other expenses of ownership. If you think you may want to do this, have a tax pro run the tax numbers and help you set up the books for this potential fringe benefit.

Stock Options and ESOPs

Tax rules for granting stock options as a fringe benefit to corporate employees are usually too complex for a small business C corporation. This is not to say you can’t let an employee buy shares of your corporation at some point—they just can’t be formally offered as a tax code qualified fringe benefit.

However, in a financially successful C corporation business, an ESOP, or Employee Stock Ownership Plan, may make sense, particularly when you are passing a business ownership on to a younger generation or long-time employees. The technicalities are beyond the scope of this book and require the help of a business attorney. (IRC §§ 421, 422, and 423.)

Fringe Benefits in a Nutshell

- Fringe benefits are valuable additions to a business owner's or employee's compensation.
- A fringe benefit is tax deductible to the business and either wholly or partly tax free to the recipient.
- The tax code imposes strict rules and limits on fringe benefits.
- Tax-advantaged retirement plans are the most valuable dollarwise of all business-related benefits, providing both long- and short-term tax savings.
- Motor vehicles for use on and off the job are a prime fringe benefit.
- The widest range of fringe benefits is available to C corporations, but fringes alone don't justify the expense of incorporating.
- Travel for business—with some pleasure mixed in—is a popular fringe benefit.
- Clubs and athletic facilities are only allowed as fringes in limited circumstances.
- Health plans as employee fringes are often too expensive for most small businesses.
- Education can be a fringe benefit but generally it must be directly related to the employee's or owner's work.

Resources

- IRS Publication 560, *Retirement Plans for the Self-Employed*.
- IRS Publication 502, *Medical and Dental Expenses*.
- IRS Publication 503, *Child and Dependent Care Credit*.
- IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.
- IRS Publication 535, *Business Expenses*.
- IRS Publication 970, *Tax Benefits for Education*.
- IRS Publication 968, *Tax Benefits for Adoption*.
- IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*.

Final thought: *"Money is a sixth sense, without which it is impossible to enjoy the other five."*

—W. Somerset Maugham

Retirement Plans

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“No man who knows what the law is today can guess what it will be tomorrow.”

—Alexander Hamilton

Only the most wide-eyed optimist believes that Social Security will provide enough money for our golden years. Indeed, as the ratio of workers to retirees shrinks, Uncle Sam effectively reduces Social Security benefits by taxing recipients on outside income. The answer: Create a supplemental retirement plan or plans.

Congress helps business owners and their employees save for retirement. It's a fact that retirement plans help businesses attract and keep talented employees. Any kind of business—corporation, partnership, sole proprietorship, or limited liability company—can set up one or more tax-advantaged retirement plans. If you're self-employed without a retirement plan, you are missing one of the greatest tax benefits of all.

Tax rules on retirement plans are complicated. This helps explain why only a third of small businesses offer retirement plans, compared to five-sixths of major companies.

At a minimum, you should have an IRA. This can be set up online in about five minutes. Download and mail the required forms to a financial institution and you have a retirement plan.

This chapter outlines retirement plan options. First, get familiar with retirement plan basics, and then select one or more that fit your needs.

Many financial institutions and professionals are available to help you implement these options. Stock brokerages, banks, and insurance companies offer retirement plan advice, mostly to sell their investment products. Also, independent pension consultants, CPAs, and financial planners can help with the more complicated plans.



CAUTION

Expect continuing changes in the law.

Rarely does a session of Congress go by without changes

being made to retirement plan rules. Check with a tax pro or online at www.irs.gov to get the latest rules.

Advantages of Retirement Plans

Small business retirement plans share these tax attributes:

- Contributions by an owner or employee are tax deductible from current income, thus reducing present income taxes.
Contributions must come from earned income, meaning compensation for active work (not investing or inheritance). An investor in a business who isn't active in it can't deduct contributions to its retirement plan. Neither can a landlord contribute to a plan based on his rental income.
- Income from investments in your retirement plan accumulates tax-free until it is withdrawn, usually after you retire.
- There are penalties for taking money out of a plan before age 59½, but some early withdrawals are allowed without penalty.
- When you retire, withdrawals from your plan are usually taxed at a lower rate than when you were working, as you will likely be in a lower tax bracket.



TIP

Don't overlook the retirement savings tax credit. Self-employed people can snag a tax credit of up to \$1,000 (single) or \$2,000 (married) by contributing to certain retirement plans such as IRAs and 401(k)s. The catch: Your adjusted gross income as shown on your individual income tax return must be less than \$27,750 (single) or \$55,500 (married). (2011 limits.)

Clearly, retirement plans are a deal that is hard to refuse. Not only can you put aside money before it's taxed, but as long as you keep your hands off it, it will grow tax-free if it's invested wisely.

Plan participants contributing \$5,000 to \$8,000 a year can build up \$150,000 to \$400,000

over a ten- to 20-year period, depending on how plan investments perform. If you contribute early in your career and continue for 20 or more years making maximum contributions, you might accumulate several million dollars.

The keys to retirement plan success are to start early, make the largest contributions you can, and take full advantage of all that the law allows.



TIP

What if you don't have the funds to make a contribution? Many people find themselves without the money to put aside for annual retirement contributions, and lose the opportunity once the year passes.

If it comes time to make your annual contribution to a retirement plan, and you come up short, get creative. Borrow money from wherever you can, because the long-term tax savings will outweigh your borrowing costs. Or liquidate any nonretirement investments and use the funds for the plan contribution. Again, even if there is tax from selling an investment, the retirement plan benefits will likely outweigh it.

A retirement plan contribution is the only way I know to do any tax reduction planning after the year has passed. (You can make contributions between January 1 and April 15 of the next year, or up to October 15 if you file an extension.)

Overview of Retirement Plan Types

Rules, rules, and more rules govern who can get into which retirement plans and how much money can be contributed each year.

Learning the rules can get confusing fast, but is well worth the effort. When you're finished reading this chapter, if you want more punishment, see IRS Publication 560, *Retirement Plans for the Self-Employed*.

Here are the different types of retirement plans—starting with the simplest. The differences

between plans are largely a matter of the limits on the annual contributions and rules on withdrawals.

- **Individual Retirement Accounts (IRAs).** Set up by individuals, not by the business itself. There are three different kinds of IRAs—the traditional IRA, the Roth IRA, and the SIMPLE IRA.
- **Simplified Employee Pension Plans (SEPs).** Annual contribution limit of the smaller of 25% of compensation (or net business income) or \$49,000 (in 2011).
- **SIMPLE IRAs.** Annual contribution limit of \$11,500 (in 2011), plus an extra \$2,500 for individuals who are age 50 or older. Plus, the business can match a worker's contribution up to 3% of the employee's compensation (or net business income) up to \$11,500, or \$14,000 for age 50 and older. If an employee's contributions are not matched, the employer can make a flat contribution to the plan of up to 2% of the employee's compensation, up to \$49,000, whether or not the employee contributes.
- **Profit Sharing Plans (PSPs).** Same annual contribution limits as SEPs (see above), except the 25% limit is applied differently. Also, PSPs have differing rules on eligibility and the rate of contribution between employees and business owners.
- **Traditional 401(k) and Roth 401(k) Plans.** Annual contribution limits of \$16,500 per owner or employee, plus another \$5,500 for individuals who are age 50 or older (in 2011). Participants can elect each year to contribute to the company's 401(k) plan. Employer may (but isn't required to) match a portion of the amount contributed by the employee.
- **Money Purchase Plans (MPPs).** Same annual contribution limits as PSPs (see above). Recent changes in the law have rendered MPPs obsolete.

- **Defined Benefit Plans (DBPs).** The annual contribution limit is based on complex actuarial formulas, allowing up to \$195,000.
- **SIMPLE 401(k)s.** These plans are so overly complicated that they are rarely ever used. They require a pooled trust and time-consuming paperwork. We don't recommend them, and they won't be discussed further.

Choose the retirement plan that best serves your needs at the time. This usually means the one that allows you to make as large a contribution as you can afford. Then, as your business matures and you advance toward retirement, review your plan each year. Chances are your needs will change, and Congress will have altered the rules. You may want to add plans to those already in place or transfer funds from old to new plans.

Details About Each Type of Retirement Plan

Let's look more closely at the contribution and participation rules for each of the plans discussed above. Later, we'll discuss the rules on withdrawing money from these retirement plans.



TIP

Contribute to retirement plans as early in the year as you can. No matter what type of plan you choose, don't hold off in making annual contributions if you have the money available. Typically, people contribute just before they file their tax returns. This means you could miss a full year of tax-free compounding!

Individual Retirement Accounts (IRAs): Traditional and Roth IRA Plans

Anyone with earned income can contribute to an individual retirement account, called an IRA.

Earned income simply means money from work, as opposed to collecting dividends or interest or capital gains from the sale of assets.

Investments in IRAs compound, without being taxed, until the money is withdrawn. IRAs can be invested in a number of things—typically, stocks, bonds, and mutual funds.

It's okay to have an IRA even with other retirement plans in place (see below).

An IRA is a fine starter plan, but may not be enough when your golden years arrive. The annual contribution limits are too small to provide for most peoples' retirement income needs.



TIP

Take advantage of the multiple uses of IRAs. IRAs aren't just for retirement; they can also be used for savings accounts to fund your children's education, medical expenses, and first-time home ownership. (See below for details.)

Traditional IRAs

First we'll discuss the rules for so-called traditional IRAs, and then we'll look at the Roth IRA.

Contribution limits. The IRA contribution limit is \$5,000 per year, plus another \$1,000 per year for individuals age 50 and older. You can contribute less to an IRA; this is just the maximum you can put in.

Spousal IRAs. There's an added break for married couples. Stay-at-home husbands or wives can contribute and deduct up to \$5,000 per year to a spousal IRA, plus an additional \$1,000 for those who are age 50 or older. The working spouse must earn at least as much as the IRA contribution made for the nonemployed spouse. Spouses can't share the same account—each must have a separate IRA. A \$6,000 contribution could shave off as much as \$2,150 in federal taxes on a joint tax return.

Some Key Small Business Retirement Plan Rules (2011)

Type of Plan	Last Date for Contribution	Maximum Contribution
Traditional and Roth IRA (Good for sideline businesses and those with limited funds. Phase-out of benefit for high earners.)	Due date of individual income tax return (NOT including extensions)	Smaller of \$5,000 or taxable compensation (\$6,000 for those age 50 or older)
SIMPLE IRA	Due date of individual income tax return (plus extensions)	Up to \$11,500, or \$23,000 if employer makes matching contributions Additional contribution of \$2,500 may be made for individuals 50 and older, plus a \$2,500 optional matching contribution by the business.
SEP IRA	Due date of employer's return (plus extensions)	Employer: Smaller of \$49,000 or 25% of participant's taxable compensation Self-Employed Individual: Smaller of \$49,000 or 20% of taxable compensation
Traditional 401(k) and Roth 401(k)	Due date of employer's return (plus extensions)	Smaller of \$16,500 or 100% of participant's taxable compensation Additional contribution of \$5,500 for individuals 50 and older.
Profit Sharing Plan	Due date of employer's return (plus extensions) To make contributions to a new plan in a given year, the plan must be set up by the last day of the employer's tax year.	Employer: Smaller of \$49,000 or 25% of employee's taxable compensation Self-Employed Individual: Smaller of \$49,000 or 20% of self-employed participant's taxable compensation
Defined Benefit Plan	Due date of employer's return (plus extensions) To make contributions to a new plan in a given year, the plan must be set up by the last day of the employer's tax year.	Up to \$195,000 or the amount needed to provide an annual retirement benefit no larger than 100% of the participant's average taxable compensation for his or her highest three consecutive years Requires actuarial computation by an enrolled actuary. The IRS won't provide this service. Tax reporting should be done only by a pension professional or specialized tax pro.

Note: A six-month extension to file your tax return is automatically granted when you file IRS Form 4868 on or before April 15.

Relationship to other retirement plans you have. If you participate in a so-called qualified retirement plan at your business, you can still have an IRA. However, your IRA tax deduction is reduced once you earn more than \$56,000 (single) or \$100,000 (married). The deduction is phased out entirely once you earn more than \$66,000 (single) or \$110,000 (married). These phase-outs apply only if you are covered by a retirement plan at work.



TIP

You can contribute to an IRA even if you're over the limit. If you're otherwise covered by a qualified plan at your business, you can still contribute to an IRA—but you don't get a tax deduction for it. However, you still get the IRA's tax-deferred earnings benefit.

Other tax rules. You can make contributions to an IRA only if you have earnings from work. This eliminates folks who live on unearned income like interest, dividends, or income from rental property.

Deadlines. You have until April 15 to establish and contribute to an IRA for the preceding year (or if you file an extension Form 4868, until October 15).

Withdrawal rules. There is an early withdrawal penalty of 10% if you make an IRA withdrawal before age 59½—with two big exceptions:

- **First-time home buyers** or their close family members may withdraw up to \$10,000 within four months of the purchase of the home.
- **Higher education expenses** of an IRA account owner or immediate family may be withdrawn from the account. (Also, see “Coverdell Education Savings Accounts,” below, covering both primary and secondary school expenses.)

Income tax. Traditional IRA withdrawals are taxed in the year they are taken, along with all the rest of your income at your tax rate.

Roth IRAs

The Roth IRA is an alternative to a traditional IRA. The most important difference between the two IRA plans is that Roth IRA contributions are never tax deductible.

The reason you might choose a Roth IRA over a traditional IRA is that withdrawals from Roth IRAs are not taxed—as long as you don't withdraw Roth earnings before age 59½.

Contribution limits. Roth contribution limits are the same as with a traditional IRA (see above). You can have both types of IRAs, but the overall annual contribution limit applies. No double dipping.

Relationships to other retirement plans you have. You can make Roth IRA contributions even if you have other qualified retirement plans. However, to make the maximum contribution, your overall adjusted gross income must be less than \$107,000 (single) or \$169,000 (married). The Roth IRA offers much higher earnings limits than with traditional IRA contributions (see above). If your adjusted gross income exceeds \$122,000 (single) or \$179,000 (married), you can't contribute at all (2011).

No age limit on contributions. Unlike a traditional IRA, a Roth IRA can be established after you turn 70½ years old.

Withdrawals. You may take your contributions, but not your earnings, from your Roth account at any time without penalty. With other retirement plans, you usually can't make any withdrawals before age 59½ without penalty.

Conversions. Switch your traditional IRA to a Roth IRA at any time. The catch is that the amount converted is fully taxable in the year of the switch. This could make sense in a down year for your business, when the tax consequences might be minimal. The long-term benefit: earnings on the switched funds will never be taxable, unless Congress changes the law. In deciding whether it makes sense to convert a

traditional IRA to a Roth, get help with the numbers at www.calctools.com or moneycentral.msn.com.

Traditional IRA or Roth IRA?

“Should I take a tax break now with the traditional IRA or later with a Roth IRA?” For most low- to middle-earners under age 40, the long-term benefits of tax-free compounding likely will outweigh the loss of the immediate tax deduction—so younger people may want to go for the Roth. But, for individuals closer to retirement age, and in higher income tax brackets, the immediate deduction of the traditional IRA makes more tax sense. Ask a tax pro to run the numbers both ways, plugging in your age and tax bracket, to see how the two might compare over the long run. It also may make sense for older people to convert a traditional IRA to a Roth IRA.

IRA online calculator. Morningstar.com/ira offers a free guide with calculations of tax consequences comparing types of IRAs for you.

Coverdell Education Savings Accounts (ESAs)

Similar to a Roth 401(k) for education is the Coverdell Education Savings Account (ESA), formerly called the Education IRA. Contributions to an ESA are not tax deductible and may be made by anyone who earns at least \$2,000. The contribution can be up to \$2,000 to be used for educational expenses of the contributor or his or her spouse or dependents. Withdrawals from an ESA are tax free, including any increases in value on investments in the ESA. There is no limit to the number of Coverdell ESAs that can be established for a single beneficiary over a number of years.

If funds in an ESA aren’t used for the designated beneficiary, the account may be rolled

over to another qualified person in the same family.

Annual ESA contributions are reported on IRS Form 8917, which is filed with your tax return.

Withdrawals. Withdrawals from an ESA must be used for educational expenses such as tuition, fees, books, supplies, computers, and Internet access. The money must be used for primary and secondary school or college expenses and all unused distributions must be made no later than 30 days after the beneficiary turns age 30. Alternatively, the ESA may be transferred to a related person who is under the age of 30.

Limitations. ESA contributions may be made only by individuals whose modified adjusted gross income is less than \$80,000 (single) or \$160,000 (married).

EXAMPLE: Dr. Estarch and her husband have an adjusted gross income of \$250,000. Her office manager, Leslie, earns \$55,000. Dr. Estarch can’t contribute to an ESA, but Leslie can set up two ESAs for her two minor kids and contribute \$2,000 to each ESA every year.

Other plans. You can set up an ESA even if you maintain and contribute to any other retirement plans. Most tax rules are the same for ESAs as they are for IRAs. See IRS Publication 970, *Tax Benefits for Education*, for details, and to learn about the Lifetime Learning credit, the Hope scholarship credit, and the higher education tuition and fee deduction.

SIMPLE IRAs

The SIMPLE plan (Savings Incentive Match For Employees) is hardly true to its acronym, as you’ll see below. There are two choices, the SIMPLE IRA and SIMPLE 401(k). As mentioned above, the SIMPLE 401(k) is complicated, so we’re only going to cover the SIMPLE IRA.

The two distinguishing features for the SIMPLE IRA compared to traditional and Roth IRAs is that it is designed to cover businesses with employees, and it allows larger annual contributions and deductions.



CAUTION

Contributions for all qualified employees are required. The employer must make an annual SIMPLE contribution for each employee (see below). This rule could make this type of plan too costly for many small business owners with employees.

As with traditional IRAs, earnings in SIMPLE IRAs are not taxed until the funds are withdrawn.

Contribution limits. Business owners and employees may contribute up to \$11,500 of their earnings to a SIMPLE IRA. In addition, the business owner must either match each employee's entire contribution (up to 3% of the employee's wages) or contribute 2% of the employee's wages. Unless the business is a sole proprietorship, the boss can also match his or her own contribution (and the business can deduct it). The employer's matching contribution may be less but can't be more than the employee's contribution. Participants age 50 or older can make an additional contribution of \$2,500 per year.

EXAMPLE: Winnie, age 52, owner of Winnie's Windsurfing World Incorporated, earns \$100,000. Winnie's maximum SIMPLE IRA contribution is \$11,500, plus an additional \$2,500 because of her age, plus a \$14,000 match from her business, for a total of \$28,000.

Tax deduction rules. Employer-made SIMPLE contributions are tax deductible to the business as compensation paid to employees. Contributions are not taxed to the employee until the SIMPLE account funds are withdrawn, along with any earnings on investments within the accounts (the same as with a regular IRA).

EXAMPLE: Scone, owner of Scone Land, pays Leotis, his business's manager, \$25,000 in wages. Leotis chooses to contribute 2% of his wages, or \$500, to a SIMPLE plan. Scone Land must match the entire \$500 contribution, as it is less than 3% of Leotis's wages. The total contribution for Leotis is \$1,000, all of which is tax deductible for Scone Land. Leotis is not taxed on the \$1,000 contribution until he withdraws it from the plan.

Eligibility and participation rules. Business owners must contribute funds to the plans of all long-term employees who earned at least \$5,000 that year and who also earned at least that much from the business in up to three prior years.

Withdrawal rules. Withdrawal rules and penalties are the same as for traditional IRAs; see "Traditional IRAs," above.

Setting Up and Maintaining an IRA-Type Plan

Traditional IRAs, Roth IRAs, Coverdell ESAs, and SIMPLE IRAs can be established by most mutual fund companies, banks, and stock brokerages. The cost may be nominal, or even free, to set up and maintain the account every year. IRA accounts are self-directed, meaning you make the investment decisions among stocks, bonds, or funds. Each participant reports the amount of the contribution on his or her personal tax return.

Simplified Employee Pensions (SEPs)

The simplified employee pension (SEP) is also called a SEP IRA; it follows the rules for IRAs, but has higher annual contribution limits. SEPs must cover both self-employed people and their full- or part-time employees. Contributions must be in cash; no property can be contributed.

Subject to the overall contribution limits discussed below, an owner or employee may contribute and maintain other retirement plans as well as a SEP.

Contributions aren't mandatory. Business owners can decide every year whether or not to contribute to a SEP, but can't play catch-up for any past years.

A business owner can contribute to separate SEP accounts for him- or herself and for each eligible employee and deduct the contributions as business expenses. SEPs are called noncontributory plans, because only the boss makes a contribution for everyone—employees can't make contributions to SEPs. Contributing businesses can be sole proprietorships, partners, or managing members of a limited liability company.

Contribution limits and rules. The maximum annual contribution to a SEP plan is the lesser of:

- \$49,000, or
- 25% of an employee's compensation, or 20% of the net business income of an owner (the formula is complicated, but it works out to 20%).

Only earned income from the business qualifies for a SEP contribution. This means that income from interest, dividends, and the sale of items producing capital gains can't be used to figure a SEP contribution.

EXAMPLE: Manfred's Grand Prix Scooter shop operation loses money one year, but Manfred made a gain of \$32,000 from the sale of real estate and inherited \$61,000 that year. Manfred can't make any SEP contribution.

Excess contributions penalty. There is a 6% penalty tax on excess contributions made to your SEP account, which can be waived by the IRS if you withdraw the excess right away. This typically happens to business owners who make SEP contributions throughout the year, before knowing their business's net income, on which the SEP contribution is based.

Who must be covered. If a business owner wants to contribute to his or her own SEP, she must also contribute to all eligible employees' SEPs as well. Contributions must be made to each employee in the same proportion as to the owner. If you're confused, here's an example.

EXAMPLE: Bella's Tango Studio earns \$70,000 (after deducting all expenses and one-half of Bella's self-employment tax). She can choose to contribute up to 20% of the business's \$70,000 net income (\$14,000) to a SEP account for herself. Bella pays Danielle, one of her long-time instructors, \$20,000 in wages. Bella must also contribute the maximum—25%, or \$5,000—to Danielle's separate SEP plan. Bella's business gets the tax deduction for both contributions, a total of \$19,000.

Eligibility rules. Business owners must contribute to a SEP for all employees, full- and part-time, who aren't covered by a union agreement and who have:

- attained age 21
- been employed there at least one day in three of the five prior years, and
- earn at least \$500 in the current year.

Deductibility rules. SEP contributions are not deductible from income or wages for purposes of Social Security and Medicare taxes. In other words, owners and employees must pay Social Security and Medicare taxes on all contributions they put into a SEP account. Kind of a bummer, but that's the law.

Deadlines. Owners have up to the date of filing their tax return to contribute to a SEP, including requested extensions to October 15 of the following year.

Establishing and maintaining a SEP. Professional fees for paperwork and annual tax reporting are tax deductible to the business. The costs are nominal, or even free, with some financial services companies. SEPs are set up and maintained by the same financial companies that are in the IRA

business, such as Fidelity, Schwab, and Vanguard. Shop around with banks, brokers, or mutual fund families.

You may freely change investments within a SEP account as you see fit.

You can have an unlimited number of SEP accounts. Of course, you can't contribute more than the annual limit. My wife and I have accumulated six different SEP, 401(k), and IRA accounts with different mutual fund families and brokers.



TIP

Use tax preparation software or consult a tax pro to figure out your contribution. Congress has made so many rules that it is difficult to figure out the correct contribution limits for retirement plans. Luckily, tax preparation software like *TurboTax* or a tax professional can make the computations for you.

Qualified Retirement Plans (ERISA)

The most complicated type of retirement plans are qualified, or ERISA, plans. They require much more paperwork and annual tax reporting than IRAs, SIMPLE IRAs, and SEPs, so small businesses don't use them as much.

Any type of business entity, whether a sole proprietorship, a partnership, a limited liability company, or an S or a C corporation, can establish a qualified plan.

A big drawback to qualified plans is that owners must contribute funds for most of their employees who work at least 1,000 hours in the year. This can be a significant financial burden. Generally, a small business would choose an ERISA plan only if its business is profitable and its needs aren't met by an IRA, SIMPLE IRA, or SEP plan. Nevertheless, qualified plans can be worth the expense and effort in certain circumstances. For example, large contributions may help retain valuable employees.



TIP

Tax credit for some plan set-up costs. An employer can take a business tax credit of up to \$500 per year for up to three years (\$1,500) for the business's expenses in setting up a qualified retirement plan, SEP, or SIMPLE IRA. This tax benefit is available to all businesses with fewer than 101 employees and at least one employee in the plan other than the owner and the owner's spouse.

Defined Contribution Profit Sharing Plans (PSPs)

The most common ERISA retirement plan for every sized business is the defined contribution plan (DCP), originally called a Keogh plan. The DCP has two subdivisions: the profit sharing plan (PSP) and the money purchase plan (MPP). We refer to this plan simply as a profit sharing plan, or PSP for short. (MPPs are discussed in the next section.)

Contribution limits. As the name profit sharing plan implies, annual contributions to a PSP are based on a business's profits. The owner, not the employees, makes the contribution to each participant's separate account.

A PSP doesn't require any annual contribution by the business, even if it has a profit; and you don't need profits to contribute to a PSP. Employer contributions are entirely voluntary. But, if any PSP contributions are made, everyone covered by the plan must share in the contribution. That is, the owner can't contribute funds for him- or herself without doing the same for all eligible employees.

A business owner may contribute the lesser of:

- \$49,000
- 100% of the net business income of the owner or the compensation of the employee, or
- 25% of the aggregate compensation of all PSP participants, reduced by contributions made for the owner's account.

Eligibility and participation rules. All full-time employees age 21 or older and with the business at least one year must be covered by the PSP.

Establishing and maintaining a PSP. See the section on 401(k) plans, below.

Money Purchase Plan (MPP)

The second type of defined contribution plan, the money purchase plan (MPP), now has the same contribution limits as the PSP. Formerly, the contribution limits were higher for MPPs, so they made sense. Today no one chooses an MPP, because contributions are mandatory each year—whether the business makes a profit or not. It's safe to say the MPP is now obsolete, although it's still in the books.

Traditional 401(k) Plans

Any business entity can establish a 401(k) or 401(k) Roth plan. Participants may contribute part of their wages to the plan. This is called deferred compensation by the tax code. An employer may also contribute to the plan on behalf of the employee. The employer's contribution is a deductible business expense.

Contribution limits. Each business owner or eligible employee may contribute up to \$16,500 to a 401(k). The contribution can't be more than the employee's earned income for each year. An additional \$5,000 is allowed if the individual is at least 50 years old.



TIP

Add a 401(k) and a profit sharing plan for a greater tax deduction. Under rather complex rules, you can contribute to both a profit sharing plan and a 401(k) plan.

EXAMPLE: Monte the Magician, age 51, earns \$100,000 working the showrooms of Las Vegas. Monte can contribute up to \$21,500 to a 401(k)

plan (the \$16,500 limit plus \$5,000 for being over age 50). Monte can also contribute \$21,500 to a profit sharing plan, making his total retirement plan contributions \$43,000 for the year.

Participation rules. A business's 401(k) plan must be open to any full-time employee, 21 years of age or older, who has worked for the business at least one year.

A qualified employee doesn't have to contribute to the 401(k) but should be encouraged to. All employees must contribute similar proportions of their wages as do the top brass. Otherwise, the higher-paid guys either can't contribute or can't make the maximum contribution. This would violate tax code rules against top-heavy 401(k) plans. Because employees can't be forced to participate in a 401(k) plan, some businesses offer a matching incentive. Typically, owners match half of their employee's contributions up to 6% of wages. Or a business can match a set amount, such as \$1,000, as long as the employee contributes at least that much.

Social Security and Medicare taxes. Money contributed to a 401(k) plan is still subject to Social Security and Medicare tax. For some, this extra cost causes too much shrinkage in their paycheck, so they skip making a contribution—not a good idea.

EXAMPLE: Dennis, owner of DenCo, a management consulting firm, sets up a 401(k) plan. Dennis is in the 35% income tax bracket. DenCo contributes \$9,000 into Dennis's 401(k) plan and deducts it as a business expense. The contribution is not income to Dennis, and the corporation will owe employment tax on the \$9,000 contribution. (The exact tax amount of the Social Security and Medicare tax will depend on his total earnings for that year.) This is still not bad, considering the contribution saved Dennis \$3,150 ($35\% \times \$9,000$) in income taxes. Also, there was probably a state income

tax savings, depending on where Dennis resides.

Establishing and maintaining a 401(k). 401(k) plans and trust funds for plan assets can be set up by a pension pro or a financial services company. There is more paperwork and higher initial fees and annual maintenance costs involved with 401(k)s than with IRAs and SEPs.

Businesses with 401(k)s must do a separate annual tax reporting (Form 5500) each year. This means a tax pro or financial services firm; these professional fees are tax deductible. Before setting up a 401(k), check out the costs of establishing it and the annual charges. Compare the benefits offered to the other plans discussed in this section.

Most 401(k) plans limit your investment choices. A few 401(k)s permit participants to freely play the stock market, but whether this is a wise move in a 401(k) account is another question.

Roth 401(k) Plan

A Roth 401(k) allows a business's employees to make annual contributions under the regular 401(k) rules above. Like the Roth IRA, contributions are not tax deductible. But, there is no income tax on withdrawals as with a regular 401(k) account. One hitch is that you can't take any money out before age 59½ without a penalty.

The reasons for considering a Roth 401(k) are the same as discussed in "Roth IRAs," above—the earnings in Roth account investments accumulate free of any future federal income taxes. In general, this is great for lower income people with 20 years to go before retirement, but not as good for high earners five or fewer years away from their golden years.

Another uncertainty with the Roth 401(k) decision is guessing what your income tax bracket will be when you retire; most folks assume it will be lower than when they were working, but who knows what Congress will do in the future with the tax laws.

Defined Benefit Plans (DBPs)

The defined benefit plan (DBP) is the most expensive and complicated retirement plan to set up and maintain. But, it also allows the largest annual contributions, so it offers the greatest potential tax benefits.

A DBP is designed to provide either a specific monthly payment (such as \$5,000) or a lump sum (such as \$1,200,000) upon retirement. The payment is usually tied to a formula, such as 40% of the participant's average annual compensation for the highest three years in the plan. Each year's contribution varies and is based on this target monthly or lump-sum benefit.

Eligibility and participation. All qualified employees must be included in the DBP. How much must be contributed each year for each participant depends on the person's age, length of service, and annual compensation. Age is the most critical factor. Typically, DBPs allow for the biggest contributions for those over age 45—people with shorter life expectancies.

Annual tax deductions of up to \$195,000 are possible for each participant—far greater than for any other retirement plan. The formula to determine the exact amount is complex and must be recalculated every year (see below).

Pension pro and actuary required. A DBP requires not only a sharp pension planning professional, but an enrolled actuary as well. The actuary does all of the complicated contribution computations based on participants' life expectancy, the amount of benefit the plan is expected to provide, and how well or how poorly your plan investments perform every year.

This requires annual filing of a set of forms (primarily IRS Form 5500). Expect \$2,500 or more in professional fees to establish a DBP and a similar amount every year thereafter. These fees are fully tax deductible.

Ending a DBP. Generally, you can terminate a defined benefit plan at any time by rolling the

plan investments into an IRA. Don't do this without using a tax pro to prepare the paperwork.



TIP

DBPs allow late bloomers to catch up.

A DBP is a lifesaver for highly compensated business owners and professionals who weren't able to build up retirement accounts earlier in their careers. At age 50, I started a DBP and am overjoyed at the large tax savings it gives me every year—sometimes as much as 100% of my earnings from writing and practicing tax law can be contributed and deducted. This is by far the largest single tax deduction on my return.

Miscellany. Participants may borrow from DBPs and may be covered by other types of retirement plans as well.

Where to Go for a Retirement Plan

For most small business owners, a ready-made retirement plan is fine. Fidelity Investments, Vanguard, and Charles Schwab are low-cost financial institutions I've worked with that set up and maintain most kinds of plans. It can usually all be done online and by mail. The financial institution will automatically take care of the annual IRS reporting required by most tax-advantaged retirement plans. (For custom plans, such as defined benefit plans, this paperwork should be tackled by an accountant, plan administrator, or pension pro.)

As your business grows and you near age 50, talk to a pension or tax professional to make sure you are maximizing retirement plan opportunities.



SEE AN EXPERT

Choosing a retirement pro. Generally, if you are choosing an IRA or a SEP, there is no need to see a pro. If you need advice on other plans, find

someone who is truly independent—meaning he or she is compensated by you on an hourly or flat-fee basis and not from commissions on investments sold. Expect to pay \$100–\$250 an hour (tax deductible, of course).

Tax Credit for Professional Help

A business owner with at least one nonowner employee can take an additional tax credit of up to \$500 for three years for fees paid in setting up a SEP, SIMPLE or Qualified plan. This means Uncle Sam is reimbursing you for up to \$1,500 of your costs in setting up a plan—an offer you can't (or shouldn't) refuse.

Managing Your Retirement Plan Investments

You can make your own plan investment decisions or let others do it for you.

At the least, you should keep an eye on your retirement plan's performance. Most financial institutions issue monthly or quarterly reports. It's easy to change the investment portfolio or the institutions handling your plan if you're not happy.

The bulk of my retirement account funds are in the hands of a professional money manager. These people typically charge an annual fee of around 1% of the value of the account. Or, talk to a fee-based certified financial planner (CFP).

Potential Tax Problems With Retirement Plans

Retirement plan rules are so complex and ever-changing that plans sometimes fail to meet the tax rules. When problems arise, they are usually found in IRS audits of the business or its owners.

Retirement plan audits are prompted by reviews of annual Form 5500 filings (required for most types of plans, except IRAs and SEPs). The IRS

uses agents who are specially trained in retirement plans to ferret out technical violations.

IRS Publication 4224, *Retirement Plan Correction Programs*, explains how to fix defective retirement plans. There is also a CD-ROM version of this publication available at www.irs.gov.

Here are some common technical violations.

Excess Contributions

The most common problem found by the IRS is that contributions made to a plan by a business owner exceed the yearly limit. As discussed, each type of retirement plan has strict annual maximums.

It's easy for an owner to over contribute, particularly if payments are made to a retirement plan throughout the year, but the business's net income isn't known until the year ends.

Excess monies should be returned to the contributors right away. If the IRS catches the mistake, a 10% tax penalty can be imposed on the excess.

Overfunded Plans (Defined Benefit Plans Only)

A defined benefit plan balance can become "too fat" under complex IRS formulas. For instance, this could happen if plan investments were projected to return 4% annually and they actually returned 8%. In this case, no further contributions can be made to the plan until projections even out. With a DBP, you should always be working with a pension pro to see that overfunding doesn't occur.

Affiliated Service Groups and Controlled Groups

A rare problem—not meeting minimum coverage requirements—may arise if both spouses own businesses and have retirement plans (other than SEPs and IRAs), and they reside in a community

property state. This is considered cross-ownership of businesses, which are (in tax lingo) affiliated service groups or controlled groups.

If this sounds like it might apply to you, consult a pension pro.

Which Is Best for Me: IRA, SEP, SIMPLE, or Qualified Plan?

By now you're probably thoroughly confused. Sorry, I'm only the messenger—blame the Alice-in-Wonderland rules on Washington. Some rough comparisons may help you decide what plan or plans work best.

IRAs and SEPs are the easiest retirement plans to set up and maintain. A SEP may be all you ever need, especially if your business has no employees. It allows you to contribute up to \$49,000 a year to a retirement plan, assuming you meet the net income requirements.

A 401(k) plan should be considered if your income isn't high enough to qualify you for the full \$49,000 SEP contribution.

If your business has employees for whom the law requires you to make contributions in order to contribute for yourself, SIMPLE IRAs and profit sharing plans are less expensive than SEPs and 401(k)s.

Defined benefit plans are the Rolls Royces of the bunch, allowing tax deductible contributions as high as \$195,000 per year. The downside is that contributions are required for all your employees, and these plans are expensive to set up and maintain (although the costs are tax deductible).

Withdrawing Money From Retirement Plans

The part we all wait for is the retirement plan payday. The only downside—other than getting old—is that the income tax bill is finally due (except for Roth IRA and Coverdell education

savings accounts, from which withdrawals are tax free).

Here is how it works. You'll owe income tax on both the original contributions and on any plan earnings that have accumulated tax-deferred over the years. The whole account is taxed at your regular income tax rate, not at the capital gains rate.

How much tax is due depends on how much is withdrawn per year and on your income tax bracket. Typically, your bracket will be lower in retirement than when you are working, which is yet another advantage of retirement plans. This could mean a drop from years in which your federal (and state) tax rate was 40% to a low of 10%. Of course, it all depends on what happens to tax rates in the future. If they go up, this advantage would be lessened or even disappear.

Until it's all gone, money in your retirement account continues to accumulate tax deferred.



TIP

Retiring to a low- or no-income-tax

state. If you live in a tax-hungry state like California, New York, Hawaii, Maine, Wisconsin, or Vermont (to name the worst offenders), consider relocating when you retire (or even before). Seven states have no state income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Two others, New Hampshire and Tennessee, tax only dividend and interest income, but not retirement plan income. Several years ago, I moved my family three miles across the California state line to Nevada. Our state income tax savings were close to \$20,000 in the first year alone! But even the no-income-tax states can get into your pockets in other ways, such as high property taxes and sales taxes. Check the state's tax laws carefully with a tax pro before you move.

Avoiding Withdrawal Penalties

Here are the rules on withdrawal penalties for Qualified plans and 401(k)s (but not for SEPs

and IRAs). To take money from a retirement plan without a tax penalty, you must fulfill at least one of the following requirements:

- you are at least 59½ years old and retired from the business that provided the plan
- you have left the business and are at least 55 years old
- you are permanently disabled
- you have medical expenses, school tuition, or are buying a home
- you have died (and since you can't "take it with you," this means your heirs or named beneficiaries get it), or
- you are subject to a qualified domestic relations order. This usually means you're divorced and the judge orders you to pay part of your retirement plan withdrawals to your ex-spouse.

Tax Withholding on Withdrawals

There is a 20% federal tax withholding for Qualified plans and 401(k)s withdrawals (but not IRAs and SEPs). This doesn't mean you owe 20% or any tax at all on the withdrawal—you won't know until you file your tax return. You may get a refund or owe more, depending on your total taxable income for the year. Keep filing tax returns to report plan withdrawals after you retire—especially if you're due a refund. Many states impose tax withholding, too.

Mixed Contribution Plan Withdrawals

Sometimes, withdrawals from retirement plans may consist of both taxable and nontaxable money. You may have made contributions to an IRA that weren't deductible. Make sure to report this properly so that you don't pay tax on the nondeductible portion. IRS Publication 575, *Pension and Annuity Income*, shows how to do this, or pay the IRS to do the calculation for you.

See IRS Publication 939, *General Rule for Pensions and Annuities*.



CAUTION

Early withdrawal penalties. If you don't follow the retirement plan withdrawal rules, you can be hit with a 10% tax penalty, plus tax due on the withdrawal.

EXAMPLE: Jocko withdraws \$10,000 from his retirement account to buy a car he needs to get to his new job. Jocko must pay a 10% penalty tax of \$1,000 plus \$2,500 in federal income tax (assuming his tax bracket is 25%). And, if Jocko lives in a state with a personal income tax, he'll owe state taxes and possibly penalties, too.

Loans From Some Retirement Plans

You may borrow from your retirement plan (except for IRAs and SEPs) if the plan documents allow it.

The borrowing limit is \$50,000 and you must provide collateral. (Generally, pledging the other half of your retirement account balance does this.) You must repay the loan with interest, at commercial loan rates, within five years. Exception: For home purchases, you get up to 30 years to repay.

Lump-Sum Withdrawals

Generally, if you take money out of a retirement fund, it is taxable that year. The principal exceptions are for Roth accounts and for people born before 1936.

Mandatory Withdrawals by 70½

Except for Roth IRAs, you must start withdrawals from your retirement plan in the year after you

turn 70½ or risk a 50% penalty tax. IRS tables show the minimum annual withdrawals required, based on IRS life expectancy tables. The intent of the law is that your retirement account is zeroed out in the year the actuaries say you will die. See Publication 950, *Individual Retirement Arrangements*, for how to determine your required minimum distributions. Also, you can use a free minimum distribution calculator at www.fundadvice.com.

What Happens at Death

At death, the balances in your retirement funds usually become part of your taxable estate. (See Chapter 12.) Qualified retirement plans automatically terminate unless your spouse is the named beneficiary.

For SEPs and IRAs only, the widow or widower can transfer the accounts without taxes being imposed into a new SEP or IRA. He or she may then choose to name younger family members as beneficiaries. This stretches the tax deferral benefits of plans even further. Don't try this without running it by a tax pro first, though.

Closing Your Business or Leaving Your Employer

If working for yourself is not cutting it—or you start up a new business—this won't affect any existing retirement plans you own, unless you withdraw the funds prematurely or terminate the plan.

If you abandon self-employment and don't make any further plan contributions, the plan investments will continue to accumulate tax-deferred until withdrawn—which might be many years in the future.

If you leave an employer, generally you may take your employer-sponsored retirement plan funds with you. To avoid a penalty tax, you must

transfer the funds into either an IRA account or a new employer's retirement plan. If you go the IRA route, you can self-manage your investments.

A business terminating its 401(k) or defined benefit plan requires the filing of various tax forms and should only be done with the assistance of a tax pro.

Retirement Plans in a Nutshell

- One of the best tax reasons for being in business is to have a retirement plan.
- Plans allow businesses to deduct contributions to accounts that accumulate tax-deferred until they are finally distributed to the retiree.
- Businesses with full-time employees usually must include all employees in their retirement plans, which can be expensive.
- All small businesses can take advantage of retirement plans.
- All distributions from retirement plans are taxable—except from a Roth IRA or an educational savings plan.
- Federal law heavily regulates retirement plans, and professional guidance for setting up and maintaining plans is advisable.

Resources

- IRS Publication 590, *Individual Retirement Arrangements* (SEPs and IRAs).
- IRS Publication 560, *Retirement Plans for the Self-Employed*.
- IRS Publication 4222, *401(k) Plans for Small Business*.
- *IRAs, 401(k)s & Other Retirement Plans: Taking Your Money Out*, by Twila Slesnick and John C. Suttle (Nolo). A comprehensive guide to various retirement plans that helps you make sense of the rules governing distributions and contains detailed information on avoiding or minimizing the taxes and penalties that can crop up when you start taking distributions.
- *Social Security, Medicare & Government Pensions*, by Joseph L. Matthews and Dorothy Matthews-Berman (Nolo). As the title indicates, this book covers the whole realm of retirement income, not just retirement plans, from a recipient's point of view.
- *How to Pay Zero Taxes*, by Jeff Schnepper (Addison-Wesley). Although the title overpromises, the book includes some innovative tax twists on using retirement plans.

Final thought: *"The trouble with retirement is that you never get a day off."*

—Jack Patterson

Buying a Business

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“The rule of my life is to make business a pleasure, and pleasure my business.”

— Aaron Burr

Instead of starting from scratch, you can usually find someone with a business for sale. Buying an established enterprise may be more costly—but less risky—than starting a new one. There’s a lot to be said for taking over a proven business with a customer base and established location.

This chapter covers the tax concerns of buying a business. The flip side, selling a business, is covered in Chapter 18. Take a look at both chapters, no matter which side of the fence you are on, to get a well-rounded tax picture.

Whether you want to acquire a service, retail, wholesale, or manufacturing business, the tax issues are remarkably similar. Once you are aware of them, you must ferret out any tax land mines.

Buyers have tax worries not faced by those who start from the ground up, such as:

- outstanding tax and other potential liabilities that come with the business, and
- potential tax audits of the business for prior years.



SEE AN EXPERT

Buyers beware—get professional advice.

An existing business may come with undisclosed taxes and debts, employee problems, overvalued inventory, and pending or potential lawsuits. Hidden liabilities can lurk in all areas—from land contaminated with toxic chemicals to accounts receivable that prove to be uncollectible to inventory that’s defective or dated.

A business-savvy attorney should be on your team for all but the smallest of business acquisitions. A lawyer can represent you through the whole process or just answer a few questions. He or she can act as an escrow agent or recommend a company to handle the exchange of money. Many attorneys don’t know the tax aspects of business transfers, so run the deal by a tax pro,

too. All professional fees here are tax deductible, and if a professional adviser screws up, he or she may be liable for any losses you suffer from the bad advice.

If the deal is big enough, say over \$100,000, consult a business appraiser, too. Find someone with expertise in valuing businesses in the same industry. This can help not only in coming up with a fair purchase price but in establishing an IRS-proof tax basis for the business assets.

Buying the Assets of a Business

A business is simply a collection of assets.

Someone offering a business for sale is trying to sell all of these assets together.

A buyer may not want everything, however. For instance, say Dayna wants to buy Sal’s Pizza Parlor because of its prime location and open a futon shop. She doesn’t want Sal’s business name or the old pizza ovens. If Dayna makes Sal a good enough offer, he may sell just the building to her and sell the rest of the items to others.

How the business is legally structured—sole proprietorship, partnership, limited liability company, or corporation—has important tax consequences to both the buyer and seller, as we’ll see.

Unincorporated Businesses

If you buy a partnership, limited liability company, or sole proprietorship, you are purchasing its assets—a store lease, inventory, customer list, and so on.

Liabilities. Normally, buyers don’t agree to take over business-related liabilities. Purchase contracts typically require the seller to pay all unsecured debts before closing, or out of escrow funds. Unpaid bills usually remain the seller’s personal responsibility after the transfer.

Debts that attach to specific assets—such as manufacturing equipment (called chattel

mortgages)—are usually voluntarily assumed by the new owner.

Tax debts. The IRS never releases the seller from unpaid taxes when a business is transferred. Buyers normally don't have to worry about the seller's tax debts, however, unless the IRS (or state taxing agency) has filed a tax lien prior to the business transfer. Tax liens appear on the public record in the name of the business or the owner. (See "Investigation," below, for how to find out whether a tax lien has been filed.)

EXAMPLE: Angelo, a sole proprietor, sells his profitable business, Korner Mart, to Luigi. Angelo has not filed or paid income taxes for the past three years. The IRS hasn't caught on to Angelo—yet. Luigi takes the business assets free of any tax liability (there are no tax liens yet). Angelo, of course, remains personally liable for taxes he should have paid on the business income before he sold the business.

Legal notice. You are not required to notify the IRS before purchasing or selling a business. However, you may need to notify state and local agencies and publish a notice to creditors under your state's Bulk Sales Act (ask your attorney or local newspaper for their form and about the procedure).

Small Business Corporations

The tax rules are different when you buy someone's incorporated business. Whether you buy corporate shares or just the corporation's assets is a crucial choice, because:

- If you buy only a corporation's assets, you don't automatically assume the corporation's liabilities, including taxes.
- If you buy a corporation's stock, you take both its assets and liabilities—including known and unknown taxes. An example of an unknown tax debt would be one from an IRS audit of the corporation that

has not yet begun. Legally, an individual seller of corporate shares is released from all corporate debts unless he or she agrees in writing to be liable for them after the stock is transferred. A good buy-sell agreement would cover this situation.

Why, then, would anyone consider buying a small business corporation's stock, given the potential for legal trouble? Because some owners will sell only if a buyer takes the stock. There are several valid reasons a seller might insist on this arrangement. One is to get rid of any potential audit tax liabilities. More likely is that the seller has a tax savings motive for selling the corporation's stock instead of its assets.

Buying Shares of Stock

Buyers of the stock of a small business corporation take over any tax debts of the business—disclosed or not—along with its assets. For instance, a potentially devastating audit tax bill can be inherited from a corporation that misclassified its employees as independent contractors.

EXAMPLE: Renate buys all of the stock of XTC corporation from Kendra. Unbeknownst to Renate, XTC's employment tax returns were not filed or taxes paid two years ago. When Renate buys the stock, no tax liens had been filed. When the IRS catches on, the corporation (now owned by Renate) will be held liable for the old payroll taxes—whether Renate knew about them or not. Renate may have a claim against Kendra, but the IRS doesn't care about that. Kendra is also personally liable to the IRS for the payroll taxes.



TIP

Get a written guarantee. Your purchase contract should include a legally binding promise from

the sellers that the corporation doesn't owe taxes and that the sellers are personally liable to the buyer if this turns out not to be true. (In legal lingo, the sellers agree to indemnify the buyer.)

Before buying corporate shares in a small business, see a tax pro. Ask about the potential for undisclosed tax liabilities, and do some investigating (discussed just below). But know that even with the best investigation of a corporation and its owners, it's impossible to predict some future tax problems. No one knows whether the IRS (or any state taxing agency) will audit tax returns the corporation filed before you bought its shares.

Take the following steps to minimize future problems.

Investigation

You'll need to gather all sorts of documentation from and about the seller. This is called doing due diligence.

Tax returns. Ask the seller for copies of all business income tax returns and employment tax returns for the last three years. Demand proof that taxes have been paid. Copies of filed tax forms, along with canceled checks, should be provided once you have signed a purchase contract with the seller. (Your agreement should provide for an inspection of the business books, and the right to back out if irregularities are found.)

Consider hiring a business attorney or tax pro to help check the seller out. Your expert should look for signs of unreported income, unfiled tax returns, and unpaid taxes. Is there anything that doesn't jibe with what corporation records should show? If a red (or even a pink) flag is raised, probe further.

Exactly what to look for depends on the type of business you are buying. For instance, if independent contractors are used in the business, check whether Form 1099s have been filed and other IRS reporting rules were met. (See Chapter 6.)

If a corporation's tax returns look strange to your tax pro, ask why. If items catch your attention, they might interest an IRS auditor as well.

Personal credit reports. You should also require selling shareholder(s) to furnish personal credit reports; be suspicious if they won't. Tax liens against the individual shareholders may show up on their personal credit reports, which may be a tip-off as to how they have conducted their business affairs.



TIP

Put a disclosure requirements clause in the purchase contract. Use a clause similar to this one: "Seller agrees to furnish copies of all business income and employment tax returns for the past three years within ten days of acceptance of this offer. Seller will give full access to all business records to buyer or his representative, for the purposes of verifying that there are no present or potential tax liabilities. Seller will provide a copy of a current credit report on all shareholders of the corporation."

Information from the IRS. Sellers often lie about business income and expenses. I've even seen them dummy up tax returns. Without confirmation from the IRS, you won't know whether or not the returns shown to you are the real thing. The solution: Require in your purchase agreement that the seller give you a signed *Tax Information Authorization* (Form 8821) for the individual owners or shareholders as well as the business. This form, available on the IRS website (www.irs.gov), allows you, or your attorney or tax pro, to access the seller's IRS tax history. Allow several weeks for the IRS to send computer printouts showing a business owner's (or corporation's) tax filing and payment history, and if any taxes are owing. Pay particular attention to whether all quarterly Form 941 employment tax returns were filed. Compare the tax disclosures the seller provided against the IRS records.

IRS printouts are free, but are in IRS code and may be difficult to decipher. Ask a tax pro to analyze them, or call the IRS and ask for an explanation.

Public records. Your county records office has books or computer files showing recorded federal and state tax liens against a business or its owners. If taxes are owed, the IRS may have recorded a Notice of Federal Tax Lien. Liens bear the tax ID number (either the Social Security or employer identification number) of the business or its owners.

Look up the names of the owners and the business's name in your county recorder's office or land registry office. Search records by computer, microfiche readers, or handwritten record books, depending on your locality. Ask a clerk for help, or hire a credit bureau, title company, or attorney to search the records for you.

EXAMPLE: Harold wants to know if Alco Motors, Inc., or Al Coors, its principal shareholder, has outstanding tax bills. He goes to the county records office and searches the name index for "Alco Motors, Inc." and for "Al Coors." Harold looks back ten years, because this is how long a tax lien is normally valid. No liens appear. This is a positive sign, but not a guarantee that Alco Motors or Al Coors doesn't owe taxes—it just means that no liens appear on the records.



CAUTION

Checking public records is not foolproof.

The IRS doesn't always file lien notices on tax debtors. So the absence of a tax lien doesn't mean you are home free.

UCC and state records. Check for state tax or other liens with your state's secretary of state or department of corporations (official titles vary from state to state). As with searching local records, you can do it yourself or hire an expert.

Get state lien information by sending a Form UCC-3 to your secretary of state's office with a small fee. ("UCC" means Uniform Commercial Code, a set of laws that has been adopted in most states.) UCC forms are available from the Internet and your secretary of state's office (many state agencies have websites from which you can download forms) or from stationery stores, reference libraries, business attorneys, or accountants.

The state sends back a UCC filing report showing state tax liens, judgment liens, and financing liens on business equipment. UCC reports, however, are often incomplete or not up-to-date.

Indemnification

Your buy-sell contract should provide that the seller of stock promises to pay any undisclosed taxes and other unknown liabilities discovered by the buyer after the closing. While this indemnification clause obligates the seller, if the seller disappears or can't pay, the pledge will be worthless. Your corporation will be stuck with the old tax liabilities, so protect yourself as best you can.

Holdbacks and Offsets

What is your best protection from unknown tax liabilities when buying stock? Require part of the purchase price (perhaps 5% to 30%) to be kept in an account with an escrow company, attorney, or bank after closing.

This holdback money is earmarked to pay any corporate liabilities, including taxes discovered after the sale. The longer money is held back for contingencies, the better. Understandably, most sellers won't agree to holdbacks for longer than a few months. However, many sellers will agree to a longer period if the holdback account pays interest to them. Make this part of your negotiations.

Alternatively, if you aren't paying for the stock in full (if you're paying some cash up front with an installment promissory note for the balance), you should always include an offset clause in your buy-sell agreement. This lets you reduce promissory note payments by the amount of any undisclosed taxes or debts discovered after closing.

Assigning a Price to Business Assets

As you negotiate the purchase of a business, you'll be evaluating each of its assets. The tax code requires buyers and sellers to jointly agree on the amount of the purchase price allocated to each business asset or group of assets. (Amounts allocated must be at the fair market value.)

A buyer should use these same values to calculate the tax depreciation deduction for each asset, and to figure the taxable gain or loss when the buyer later sells or disposes of the asset or the whole business.

The overall price paid for a business usually reflects how eager the parties are to make a deal, not how much each item is really worth. Asset value allocations have great tax significance to a buyer but may not be important to a seller.



TIP

Back up major asset valuations with appraisals. Professional appraisals are recommended, especially for deals over \$250,000. If either side is ever audited, the IRS may question the asset valuations and allocations, and you'll need some backup. If the numbers are not in line with fair market values, the IRS can refigure them. This usually results in longer depreciation periods for the assets, which decreases a buyer's annual tax deductions—and produces an audit bill for the IRS's efforts. (See "Resources" at the end of this chapter for help finding an appraiser.)

EXAMPLE: Tony buys Ace Tool & Die from Jim for \$950,000. After hiring an appraiser to determine

the fair market value of each asset, Jim and Tony agree to allocate the purchase price as follows: \$650,000 for machinery, \$100,000 for goodwill, and \$200,000 for a patent right. If either Tony or Jim is audited, they can produce a report from the appraiser backing up their allocations.

Classifying Assets for the IRS

A breakdown of the business purchase price is reported on Form 8594, *Asset Acquisition Statement*. Both the buyer and the seller file this form with their income tax returns in the year after the transaction. (A sample Form 8594 follows.)

The IRS allocation reporting process has two steps: First, divide the assets into the seven classes discussed below. Second, assign dollar values to each class according to tax code rules.



SEE AN EXPERT

Get help with Form 8594. Classifying assets is complicated, and the IRS rules in this area can be vague. The form is deceptively simple, so consult a tax pro. Also, see Regulations 1.1060-1 and 1.338-6.

Allocation to Seven IRS Classes

Here's how the asset allocation process works:

Business buyers and sellers must break down the transferred business assets into seven classes. (IRC § 1060(a).) Each class has different tax consequences, especially to a buyer. Naturally, most buyers want to classify assets in a way that gives them the biggest tax write-offs.

Here are the seven asset classes:

Class one. Cash, demand deposits, and similar accounts in banks, savings and loan associations, and other depository institutions. Typically, the only cash transferred is minimal amounts in petty cash or in business checking accounts. Sellers

usually clean out the cash drawer, making the figure zero.

Class two. Assets that can be easily converted to cash, including certificates of deposit (CDs), U.S. government securities, foreign currency, publicly traded stocks, and securities.

Class three. For all but a handful of businesses, the only asset in class three that is likely to apply is the accounts receivable of a business being transferred. But most buyers don't want the responsibility of collecting the former owner's accounts, so often these accounts receivable are not part of a business purchase and sale anyway.

Class four. Inventory offered for sale to customers is the main asset in this category. When a buyer agrees to purchase the existing inventory of a business, some of the goods are often unsaleable for one reason or another. In this case, a buyer should heavily discount the value of the inventory for allocation purposes.

Class five. A catchall for assets that don't fall into the other classes, including furniture and fixtures, land and buildings, and equipment. Some items in class five that deserve special attention are:

- **Land, buildings, and leases.** These items provide some of the biggest tax deductions the buyer is going to get out of the deal, so it pays to get a friendly, tax-savvy real estate expert to come up with written valuations.
- **Machinery and equipment, furniture, and fixtures.** These tangible items typically produce the fastest tax write-offs for buyers, so hopefully the buyer can allocate a significant portion of the purchase price to these assets. If a significant amount of business equipment is being transferred, get a written valuation from a dealer. For run-of-the-mill desks, chairs, and water coolers, you can get by with rough estimates of the used value.

Class six. Intangible assets, except for goodwill and going concern value. An intangible asset is usually a legal right, rather than a thing that can

be touched or physically possessed. Examples include patents, copyrights, designs, formulas, licenses, government-granted rights, covenants not to compete, trademarks, customer lists, and customer- or supplier-based intangibles (such as long-term contracts).

Generally, intangible assets have longer write-off periods than tangible assets—usually 15 years. Plus, accelerated depreciation methods are not allowed for intangible assets; deductions must be taken in equal annual amounts—which means $\frac{1}{15}$ of the cost per year for 15 years. This means it will take a buyer a long time to write off the cost of intangible assets.



SEE AN EXPERT

Intangible assets are difficult to value. For valuable items, get valuations from a CPA or business valuation specialist.

Class seven. The only asset in this class is goodwill, or going concern, value.

Goodwill consists of name recognition, reputation, and customer relationships of an existing business. If the price paid for a going concern exceeds the fair market value of all the rest of the assets, the IRS considers that the excess was paid for goodwill.

EXAMPLE: Sam pays \$100,000 for Honest John's Network Communications Emporium. The cash and tangible assets of the business add up to \$69,000: \$1,000 in the cash drawer, \$15,000 in inventory on hand, \$3,000 worth of machinery, and a building worth \$50,000. Why is Sam willing to pay \$31,000 more than the value of all of the company's identifiable assets? Because Honest John's has a good location and a solid customer base. Sam thinks that a lot of John's customers will stick around, so he pays this premium for the business's goodwill.

Sample Form 8594

Form 8594 (Rev. February 2006) Department of the Treasury Internal Revenue Service	Asset Acquisition Statement Under Section 1060 ▶ Attach to your income tax return. ▶ See separate instructions.	OMB No. 1545-1021 Attachment Sequence No. 61
Name as shown on return Stan T. Mann d/b/a Stan's Surf Shop		Identifying number as shown on return 94-0000000
Check the box that identifies you: ☐ Purchaser ☒ Seller		
Part I General Information		
1 Name of other party to the transaction Wilde N. Wunnerful		Other party's identifying number 82-33333
Address (number, street, and room or suite no.) 77 Sunset Strip		
City or town, state, and ZIP code Malibu, CA 33333		
2 Date of sale 6/05/20xx		3 Total sales price (consideration) \$250,000
Part II Original Statement of Assets Transferred		
4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	\$ 0	\$ 0
Class II	\$ 0	\$ 0
Class III	\$ 0	\$ 0
Class IV	\$ 80,000	\$ 80,000
Class V	\$ 45,000	\$ 45,000
Class VI and VII	\$ 125,000	\$ 125,000
Total	\$ 250,000	\$ 250,000
5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? ☒ Yes ☐ No If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? ☒ Yes ☐ No		
6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? ☐ Yes ☒ No If "Yes," attach a schedule that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.		
For Paperwork Reduction Act Notice, see separate instructions.		
Cat. No. 63768Z		Form 8594 (Rev. 2-2006)

Assigning Dollar Values to the Classes

After the buyer and seller divide the assets into seven classes, they must agree on dollar values for each class. They do this by allocating a part of the purchase price to each class.

EXAMPLE: Gunter, a sole proprietor, owns Geowhiz, a geothermal energy consulting firm. Kinte agrees to buy Geowhiz for \$100,000. They make the following asset allocations:

- Class one: \$1,000 in the business's bank account at the time of the transfer
- Class two: zero
- Class three: zero
- Class four: zero
- Class five: \$14,500, the fair market value of office equipment included in the deal
- Class six: \$42,000 assigned to Gunter's patent on a small geothermal measurement instrument (professionally appraised)
- Class seven: \$42,500, the remaining sum, necessarily goes to goodwill by default.

The allocation will determine how quickly Kinte, the buyer, can write off the cost of the various assets and also Kinte's gain or loss when he later disposes of these assets.



SEE AN EXPERT

A tax pro can help you make the best allocation. The buyer and seller should agree on the allocation of asset costs as part of negotiating for the business. Because there is almost always flexibility in valuing assets, the buyer should propose the allocation of the purchase price in a way that provides the most tax benefit.

Typically, buyers should allocate as much of the purchase price as possible to assets with the biggest and fastest tax write-offs—that is, those with the shortest depreciation periods. If it's realistic, attribute the lion's share to tangible assets, like equipment which can be depreciated over as few as three years.



SEE AN EXPERT

The amount allocated to an asset shouldn't exceed the fair market value of the asset. If an IRS auditor finds the allocation unreasonable, he or she can reallocate your stated value. That's why it's a good idea to back up your allocations with an expert opinion.

Conversely, smaller values should be assigned to intangible assets, like copyrights and covenants not to compete, because they have 15-year write-off periods. Keep in mind that commercial real estate, with a depreciation period of 39 years, requires the longest time to write off.

State and Local Transfer Taxes

The state, county, or city where the business or its assets are located may impose a transfer tax on either the buyer or the seller. This is common whenever real estate changes owners.

If the transfer tax is on the seller, then your buy-sell agreement should provide that it be paid out of escrow at closing. Be aware that if the seller doesn't pay a transfer tax, the taxing agency may come after the buyer or the business assets.



CAUTION

Make sure state and local taxes are paid off. Some states or localities impose annual taxes on business fixtures and equipment or inventory. Ask for proof that these types of taxes are not delinquent, or are paid at the time of closing—or else you might inherit them.

Buying a Business in a Nutshell

- The tax law treats acquiring a business as buying a collection of assets.
- A buyer and seller must assign values to all assets and divide them into seven classes.
- The buyer and seller must report values of assets jointly on Form 8594 with their tax returns.
- Buyers can write off the costs of specific business assets depending on the tax rules for the specific type of asset.
- The buyer must write off business goodwill and other intangible assets over 15 years.
- There is no federal tax on the buyer of business assets but states and localities may impose transfer type taxes on buyer, seller, or both.
- Buyers should always do their due diligence, being wary of outstanding debts of the business (including tax liabilities).
- A buyer should require indemnification from the seller for any tax or other liabilities discovered after the transfer and also require a portion of the purchase price to be held back for a period of time.

Resources

- IRS Form 8594, *Asset Acquisition Statement*, and instructions. The instructions provide more details on allocating business assets.
- *The Complete Guide to Buying a Business*, by Fred Steingold (Nolo). A comprehensive, practical guide to buying a business.
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This self-help book has a lot of nontax pointers on buying a business.
- *Quicken Legal Business Pro*. This software includes purchase agreements with comprehensive instructions.
- To locate an appraiser of business assets, ask your tax pro, check the yellow pages under "Appraisers," or go to www.appraisers.org, www.go-iba.org, or www.nacva.com. Look for a member of the American Society of Appraisers.

Selling or Closing a Sole Proprietorship

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“The business of America is business.”

—Calvin Coolidge

This chapter focuses on the tax consequences of selling a sole proprietorship. The flip side, buying a business, is covered in Chapter 17. To get a well-rounded tax picture, take a look at both chapters.



RELATED TOPIC

If you are not a sole proprietor, go to these other chapters:

- Selling a corporation’s shares is covered in Chapters 7 and 8.
- Transferring a partnership (or limited liability company interest) is covered in Chapter 9.

Congress, realizing that there are opportunities for people to play tax games on business transfers, has enacted laws to ensure that Uncle Sam gets his cut. To pass IRS muster, the sale of a business must be tax reported correctly.

Whenever you dispose of a business asset, you might have a taxable gain, and Uncle Sam wants his share of it. On the other hand, if you have a loss from the sale, there may be a tax savings opportunity.

For the IRS forms needed when you close your doors for good, see the Tax Checklist When Closing Down at the end of this chapter.

If worse comes to worst, bankruptcy may be the best way to go out of business. The tax obligations and filing responsibilities in a bankruptcy are beyond the scope of this book. For information on bankruptcy, see IRS Publication 908, *Bankruptcy Tax Guide*, or go to Nolo’s website at www.nolo.com for information and books on the subject.

Reporting the Sale of a Sole Proprietorship

A business is just a collection of assets—typically, equipment, inventory, and goodwill. The tax code

requires that sellers and buyers assign a specific value to each asset or groups of similar assets. (The process and rules for allocating the purchase price of a business to specific assets are covered in Chapter 17.)

EXAMPLE: Harry sells his business, Bagel World, to Sally for \$45,000. They agree that the kitchen equipment and ovens are worth \$30,000; the furniture, \$2,000; computers and cash registers, \$3,000; the store lease, \$9,000; and the goodwill of the business, \$1,000. Harry’s taxable gain or loss must be figured on each of these items, as discussed below.

The seller and buyer both report the sale to the IRS by attaching Form 8594, *Asset Acquisition Statement*, to that year’s personal income tax return.

Sellers report a gain or loss on Form 4797, *Sale of Business Property*. Sole proprietors use Schedule D, *Capital Gains and Losses*, which is filed with their individual income tax returns.

Figuring Your Gain or Loss

Whenever a solo’s assets are sold, abandoned, or liquidated, each asset must be analyzed separately for tax consequences. Generally, gain or loss is determined by subtracting the owner’s tax basis from the sales price, asset by asset. If the sales price is below the seller’s tax basis, there is a loss. Typically, there will have been depreciation deductions taken on the business asset, meaning there will be an adjustment to the asset’s basis for each past year. If the sale results in a gain because the basis has been reduced to below the sales price, the result is called “depreciation recapture.” You need to analyze all the assets this way, then total them to get a reportable gain or loss.

EXAMPLE 1: Don, who owns Don’s Trucking, sells a diesel engine rebuilding machine to

Bruce for \$15,000. Don paid \$30,000 for it and had taken depreciation deductions totaling \$20,000 in past years. These deductions reduced Don's tax basis in the machinery to \$10,000. Don sells the machine for \$15,000, \$5,000 more than his tax basis. He has a taxable gain of \$5,000—even though he sold it for less than he originally paid for it. In a sense, Don is repaying the government for a prior tax deduction.

EXAMPLE 2: Now assume Don's machinery is in bad shape and he gets only \$8,000 from Bruce—\$2,000 less than his tax basis. Don has a deductible loss of \$2,000.

EXAMPLE 3: Don's machinery became worthless due to technological advances and the unavailability of parts. Don's tax basis is \$10,000 when he sells the machinery to Giuseppe, a scrap metal dealer, for \$10. Don has a tax loss of \$9,990. Don could junk the equipment himself and take a \$10,000 tax write-off. However, a documented sale to a third party looks better in case the IRS ever audits.

How Your Gain or Loss Is Taxed

Special tax rules apply when the assets of a sole proprietorship are sold. Business assets (such as equipment, vehicles, and buildings) held for at least one year are called Section 1231 assets. As such, they may or may not qualify for favorable capital gains tax rate treatment when sold.

If a Section 1231 asset is sold at a gain (meaning it's sold for more than your tax basis in the asset), the gain is taxed as ordinary income to the extent that it represents the recapture of depreciation deductions taken in prior years. Any gain over the depreciation recapture is taxed at a more favorable capital gains tax rate.

EXAMPLE 1: Don sells his diesel engine rebuilding machine for \$15,000—\$5,000 over the machine's basis of \$10,000. That \$5,000 of gain is owed to his depreciation deductions, so Don owes tax on \$5,000 at his ordinary income tax rate. Assuming Don is in the 35% federal tax bracket, he will pay \$1,750 in taxes to the IRS plus any state income taxes.

EXAMPLE 2: Let's change the facts a little. Don sells the machine for \$35,000, before taking any depreciation deductions. Don has a taxable gain of \$5,000, as in the original example, but it is now a Section 1231 gain. Don's \$5,000 gain is taxed at his capital gains rate which will likely be lower than 35%.



CAUTION

The rules are tricky, particularly for real estate. Luckily, tax preparation software makes all the calculations easy. Filling in the mind-boggling IRS Form 4797, *Sales of Business Property*, is what tax pros and computers were made for. (For all the details, see IRS Publication 544, *Sales and Other Dispositions of Assets*.)



TIP

Spread out taxes by using an installment sale. Sellers facing a large taxable gain on the sale of their business might consider selling on the installment plan.

For example, a sale with 20% down and the balance paid over five years (with interest, of course), will spread the tax on the gain over five years. This is a way, in effect, to average income. Sellers will likely be in a lower tax bracket by not getting paid all at once. Of course, there is always the risk that the buyer may not make the payments. See IRC § 453 for other rules on installment sales, or ask a tax pro to run the numbers. Form 6254, *Installment Sale Income*, must be filed with your tax return.

The Importance of an Arms-Length Deal

If a business or its assets change hands for an artificially low price, the IRS usually loses out. But often the true sales price is not clear because business transfers may involve exchanges, promissory notes, or unusual terms dreamt up by attorneys and accountants.

Sweetheart deals. Even when the sale price looks fair, the terms may not be commercially reasonable in the IRS's eyes. For instance, a business sold for no money down and paid off over 50 years at an interest rate of 3%, is not a deal any seller would make without an ulterior motive—most likely, tax avoidance. Such deals often mean a son, daughter, or other relative is the buyer. Sweetheart deals look more like gifts than business transactions.

The IRS auditor can look past the stated terms of the deal and rewrite it to reflect its true economic substance.

If you sell your business to a family member—directly or indirectly—be careful. While the IRS doesn't routinely monitor sales of businesses, if an auditor raises the issue, you must prove this was a bona fide business deal. Otherwise, the IRS can disregard your figures and terms and present you with an audit bill.

EXAMPLE: Bill, a sole proprietor nearing 70 and in poor health, sells his coffee shop chain, Moonbucks, to his son Junior for \$100,000. This price equals Bill's tax basis in the business assets of Moonbucks. It doesn't include any value for the tremendous amount of goodwill the business has built up. Any other buyer would be glad to pay \$1 million for Moonbucks. So by selling to Junior at the bargain price, Bill is avoiding income taxes and estate taxes as well (see below). If Bill were audited, the IRS would hit him with taxes on an additional \$900,000 of income, because this was not an arms-length deal.

Unrelated parties. On the other hand, if you make an arms-length deal with an unrelated party, the IRS normally won't question it.

The Estate Tax Angle

Income taxes aren't the IRS's only concern when family members are involved. The IRS is also looking ahead to collecting federal estate taxes someday. As discussed in Chapter 13, the estate tax should be considered.

Usually everything over the annual exempt amount is taxed up to 35%. To avoid estate tax, older business owners have a strong incentive to sell to relatives for bargain prices, or on special terms. (See Chapter 13 for some legitimate ways to minimize estate taxes when transferring businesses to family members.)

How to Protect Yourself From IRS Challenges

There is no way to IRS-proof yourself when selling your business, but you can do several things to reduce the odds of an IRS attack.

Set Reasonable Price and Terms

Except in very small deals, have your business assets evaluated by an expert. Valuation specialists include accountants and business brokers. Or, a seller of similar equipment or a dealer in the same type of merchandise can appraise or make offers. Keep the written opinion or offer in your files in case the IRS auditor comes calling.

If you are making a special deal for family or friends, there are some legitimate steps you can take to save taxes. Transferring your business incrementally over several years instead of all at once may be a tax planning opportunity. This is

because the tax law recognizes a minority interest discount. It works likes this:

Whenever you sell less than all of your business—for instance, a one-third interest—you are allowed to discount the value of this minority interest for tax reporting. The larger the discount, the less taxable gain to you from the sale. Reductions of 40% off the value of a minority interest in a business have been upheld in the courts against IRS attacks. (See Chapter 13, and run this by a tax pro before claiming a minority interest discount.)

Observe the Formalities

Selling an enterprise doesn't require a formal contract. The deal can be written on the back of a napkin, for all the IRS cares. The IRS's only interest is whether it is losing any taxes that should have been paid by the seller.

The more “legal” a deal appears, the less likely the IRS is to challenge it at an audit. That doesn't mean you can make anything fly with a lot of legal boilerplate and neat typing, but you are ahead of the game if you followed normal business formalities. IRS auditors are fairly unsophisticated about business practices, but some can smell a rat.



SEE AN EXPERT

Hire a business attorney. Using an attorney and producing a raft of supporting documents lends an air of legitimacy to the deal. For all but the smallest deals, have a business attorney by your side. A tax pro should be consulted as well if the size of the deal justifies the expense. Professional fees are deductible—which makes them easier to swallow.

Allocate Asset Values Fairly

When a business—or substantially all of its assets—is sold, both the buyer and seller must agree upon the value of the assets. Usually the

IRS accepts the valuations, but an auditor may question whether the overall price is fair if the parties are related (as discussed above).

The seller and buyer must attach an identical Form 8594, *Asset Acquisition Statement*, to their tax returns. If the forms aren't identical, an IRS computer cross-check might discover the discrepancy and audit the buyer or the seller or both.



RELATED TOPIC

See “Assigning a Price to Business Assets” in Chapter 17 for details on Form 8594 and for tips on allocating values to business assets.

Keep Your Records After the Sale

Good records help sell a business, but don't turn original records over to the buyer. The reason is that solos remain responsible for their period of ownership for an IRS audit. At a minimum, you have three tax years after the transfer to worry about an audit. To be on the safe side, keep records six years. (See Chapter 20.)

Tax Checklist When Closing Down

- ☐ File the final annual tax return or Schedule C.
- ☐ File final employment tax forms, Form 941 or 944, if the business had employees.
- ☐ File forms to report disposition of assets with annual return (Form 4797).
- ☐ File retirement plan forms if your business has retirement plans for employees (see IRS Publication 560, *Retirement Plans for Small Business*, or a tax pro).
- ☐ The IRS website (www.irs.gov) has details on actions needed to close a business depending on your business's structure. On the IRS website, go to the “business” page and then “closing a business.”

Selling a Business in a Nutshell

- Selling a business or its assets is a taxable event, meaning it usually produces a gain or loss to the seller that must be reported to the IRS.
- The gain or loss on assets is determined by the seller's basis in the asset.
- The IRS may challenge an unrealistic valuation of a business or an asset at an audit of the buyer, seller, or both.
- Tax rules on sales of a business depend on whether it is a sole proprietorship, partnership, LLC, or corporation.
- The IRS requires the seller and buyer to classify all assets transferred into seven categories and assign a value to each category.
- Business sales are reported to the IRS on Form 8594, which is attached to both the buyer and seller's tax returns.

Resources

- IRS Publication 537, *Installment Sales*.
- IRS Publication 544, *Sales & Other Dispositions of Assets*.
- IRS Form 4797, *Sales of Business Property*.
- IRS Form 8594, *Asset Acquisition Statement and Instructions for Form 8594*. The instructions provide more details than are given here.
- *The Complete Guide to Selling a Business*, by Fred Steingold (Nolo). A comprehensive, easy-to-use guide to selling a business.
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This self-help book has a lot of nontax pointers for sellers of a business.
- To locate an appraiser of business assets, check the yellow pages under "Appraisers" or go to www.appraisers.org, www.go-iba.org, or www.nacva.com.

When You Can't Pay Your Taxes

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“Creditors have better memories than debtors.”

— Benjamin Franklin

The IRS has enormous legal powers to collect past due taxes—it is tougher than any other bill collector you’re ever likely to face, with the possible exception of the Mafia. The IRS can seize just about anything that you own, including your bank account, home, and wages.

The IRS doesn’t need a court order or judgment before closing your business and grabbing your assets. In most cases, the IRS only has to send you a demand letter before it acts—and in some circumstances, it isn’t compelled to give you any warning at all. The IRS can even close your business down by seizing your assets or padlocking your doors.

However, the awesome IRS collection machine won’t crush you if you know how it works and you know your legal options. For instance, you can bargain for more time to pay or maybe for a reduction of the amount owed. If your financial situation is truly dire, you can request to be put on hold while the IRS bothers other poor souls.

One crucial thing to remember if you’re behind on taxes and want to stay in business is to keep in touch with the IRS. The worst thing you can do is to bury your head in the sand. A business is a sitting target; it can’t run. The IRS might leave you alone for a while, but usually not for long. Unless you are out of business, flat broke, unemployed and likely to remain that way, IRS tax collectors will be hovering.

On the plus side, the IRS collection machine is slow to start and react, which gives you time to plan your next move. You’ll get a raft of computerized tax bills and maybe IRS telephone calls, too. But it might be months or even years before you have to confront the IRS face to face. With limited personnel, the IRS tries everything before assigning a real person to your case.

Don’t get too comfortable, though, just because no one knocks on your door. Every year the

computerized IRS collection system gets bigger, faster, and meaner. Computer-generated tax liens and levies can make your life every bit as miserable as human collectors can.

And keep this in mind: Father Time is especially cruel to tax debts—they grow larger every day with mounting interest and penalties.



RESOURCE

Recommended reading. The strategies discussed in this chapter are covered at length in *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

If You Owe Less Than \$25,000

If you owe less than \$25,000, chances are your account is a fairly low IRS priority. It may be a lot of money to you, but it’s small potatoes to the IRS. Often, the IRS won’t assign a case to a collector if the balance due is less than \$25,000—but it will hound you by mail and telephone.



CAUTION

If you owe payroll taxes, there is no minimum threshold for vigorous collection efforts.

Chapter 5 explains how the IRS pursues business owners who fall behind on payroll taxes.

Getting More Time to Pay

Generally, if you can’t pay a tax bill you have received, the first thing to do is call or write to the IRS at the number or address on the bill and request more time. A request for a 30- to 120-day delay is usually honored if you haven’t called more than once or twice before. Otherwise, the IRS might only grant ten days. You can also apply online at the IRS website (www.irs.gov). If asked, explain why you need the extra time—for example, because you are applying for a loan or waiting for a customer to pay up.



TIP

Request more time to pay even if you won't be able to meet the new deadline. The IRS rarely gives you an extension longer than 120 days. It is easier to get several short extensions—a month or two—rather than one long one. This is the way the IRS operates, presumably to keep the pressure on you.

If you are granted a reprieve by phone, you should receive notice from the IRS within ten days. A new due date will be entered into the computer, but don't expect a reminder from the IRS when the time is up. Note the new deadline on your calendar; then contact the IRS before it is up if you still need more time. You may have to make a partial payment to get more time.

Paying in Installments

If you need more than a few months, ask the IRS for an installment payment agreement. A monthly payment plan relieves you of the worry that the IRS will seize your wages or assets—as long as you make payments.

You have no legal right to pay overdue taxes in installments, but the IRS usually agrees to monthly payments. *Your Rights as a Taxpayer* (IRS Publication 1) says that you have the right to propose an installment agreement, and that the IRS must fairly consider it. The hitch is that you must show you can't pay your bill in full from your present resources.

To request to pay in installments, call or write to the IRS. If writing, send a copy of the tax bill or, even better, file IRS Form 9465, *Installment Agreement Request* (available at www.irs.gov). If you have already been in contact with a specific person at the IRS, direct your request directly to that person. If the IRS agrees, you'll get written confirmation and monthly payment vouchers. For more information, see *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

If your request is granted, you pay the IRS monthly, like a credit card balance. And, as with

your Visa or MasterCard, an interest charge is added (discussed further just below). The IRS also imposes a \$105 user fee for setting up an installment plan, unless you agree to a direct debit from your bank, in which case the fee drops to \$52. If you meet poverty guidelines, the fee goes down to \$43. As mentioned above, the IRS is tough on payroll tax delinquencies, and may not allow you a long-term payment plan.

Time Limit on IRS to Collect Tax Debts

There is some justice, even in the tax world. The law limits the IRS to ten years from the date a tax is assessed to collect it. (IRC § 6402(a).) After that, you are home free! However, taking certain actions—filing for bankruptcy, making an offer in compromise, or signing an IRS tax collection waiver form—can lengthen the time limit beyond ten years. Nevertheless, since a business failure or other catastrophe can put you into a very deep tax hole, it is comforting to know that there is some light at the end of the tunnel.

Interest and Penalties

There is no free lunch with the IRS. A major downside to paying the IRS on an installment plan is that interest and late-payment penalties keep adding up. Recently, interest and penalties have averaged a combined rate of 6% to 10% per year. If your installment payments are low and the unpaid balance sufficiently large, you may find the balance you owe the IRS is increasing every month.

EXAMPLE: Carson owes the IRS \$40,000 for back payroll taxes from her failed graphic design studio. The IRS determines Carson can pay \$300 per month. She is also charged 12% interest and penalties, adding \$4,800 per year to her bill. One year later, after paying \$300

per month, Carson owes \$41,200, which is \$1,200 more than her original bill. (Carson has some other alternatives in dealing with the IRS, discussed below.)

Under \$25,000 Payment Plans

If you owe less than \$25,000, you qualify for an automatic installment payment plan. Make your proposal on Form 9465, or submit it electronically using the Online Payment Agreement Application on the IRS website (www.irs.gov).

The catch is that your proposed payments must be sufficient to pay the bill in full within 60 months. Monthly payments must be equal. Interest, around 6% annually, and late payment penalties of ¼% per month will be added.

You can always make larger payments than called for in the plan, but if you send less, the plan may be canceled. If you can't make a full payment, call the IRS to ask for permission to send less.



CAUTION

The IRS is tougher on payroll taxes. If you owe back payroll taxes—in any amount—the IRS may require detailed financial information and faster payoffs.

Over \$25,000 Payment Plans

If you owe over \$25,000, call the number on the bill or mail Form 9465 to the address on the bill. Your monthly payment amount is determined by the IRS's evaluation of the financial information it has gotten from you indicating your maximum ability to pay. The IRS may require you to use Form 433, *Collection Information Statement*.

The IRS rarely accepts less than \$50 per month, and payment plans can be as high as \$5,000 or more per month—it all depends on your financial circumstances. The IRS welcomes any payments

over the agreed-upon amount. Prepaying cuts down the interest and penalty charges that always continue to accrue during the installment plan.

If the IRS asks for more in monthly payments than you can afford—as is frequently the case—you can attempt to negotiate. How successful you are may depend on your powers of persuasion.



TIP

Make sure your requests get to the right IRS department. When writing about a bill, always send the IRS a copy of the notice, using the bar-coded IRS return envelope that came with it. This ensures that your request for more time or an installment agreement gets to the right department.

If You Fall Behind on Your Payments

If you get an installment plan, make the payments faithfully each month. If you don't, the IRS can void the agreement and start seizing your bank accounts and other assets.

If you can't make a payment, call the IRS and explain your circumstances. Ask that the agreement not be defaulted. Promise to catch up in the next month or request that the monthly amount be lowered because of an unexpected reversal of fortune. The IRS may be sympathetic and go along if you stay in touch.

If the plan is reinstated or renegotiated, you will be charged an additional fee of \$45 for this privilege.

What to Expect When the IRS Gets Serious

If you get behind on taxes, expect many past due notices over the next year or two. But if you owe more than \$25,000 in income taxes, or payroll taxes in any amount, you may be visited

by an IRS revenue officer—the elite collectors of the IRS. These folks are to be both feared and respected for their powers.

The Sneak Attack

Revenue officers usually show up at your business or home unannounced, often before 9 a.m. or after 5 p.m. The collector will start grilling you right then and there—if you let him.

Keep calm and resist the urge to curse your luck or the IRS. Instead of giving off-the-cuff answers, say that you need time to get your financial information together. Emphasize that you want to deal with your tax problems and will meet the collector at the IRS office within a week or two. Avoid making any financial commitments at this time unless you are absolutely certain you can follow through.

Meeting With the Collector

Collectors ask for information about both your business and personal finances. This data is entered on *IRS Collection Information Statement* (CIS), Form 433-A, for your personal finances and self-employment income or Form 433-B for a separate business entity's assets, liabilities, income, and expenses. See the Collection Financial Standards section of the IRS website (www.irs.gov) to see how the IRS analyzes an individual's ability to pay. After these CIS forms are completed, you will be asked to read, verify, and sign them.



TIP

Know what information the IRS wants before the meeting with the revenue officer. Obtain CIS Forms 433-A and 433-B from IRS offices, at www.irs.gov, or by calling 800-829-1040. These forms are discussed in detail in *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

Are Your Personal Assets at Risk?

Whether or not the IRS can come after your personal assets for business-related taxes—or after your business assets when you owe personal taxes—depends on the form of your business entity and the type of taxes owed.

If you operate as a *sole proprietorship*, there is no legal distinction between your business and you. Accordingly, the IRS can grab just about anything you own for any kind of tax debt.

If you are in a *partnership* or *limited liability company*, the IRS can go after your share of the property owned by the company. The IRS can also tag the personal assets of any general partner for 100% of a tax debt of the partnership.

If your business is *incorporated*, your personal assets may or may not be shielded from corporate tax bills. If a small business corporation owes payroll taxes, the IRS can go directly after personal assets of all responsible shareholders and officers (as discussed in Chapter 6).

Conversely, because a corporation is a separate tax entity from its owners, the IRS can't seize corporation assets for bills owed by its shareholders. However, if shareholders are using the corporation just to keep assets away from the IRS, the IRS may be able to reach the corporate assets. (That's why it's critical to observe corporate formalities.)

While the IRS can't usually take corporate assets to satisfy your personal tax debts, it can seize your shares of stock in a corporation. But since stock of a small business corporation is difficult to sell, the IRS rarely bothers to take it.

Don't be rushed into signing a CIS. Data on these forms is the key to further IRS collection efforts. A misstatement or wrong figure—intentional or not—is not easy to correct.

Resist pressure from a collector to complete and sign the financial forms at the first interview. Ask for time to review them. Explain that you want to be sure everything is correct and that your memory is not good enough to do it right then and there; you need to check your records first.



CAUTION

Beware of the “necessary living expenses” trap. When filling out a CIS, pay strict attention to the “necessary living expenses” questions. This is the crucial area in the IRS determination of how big your payments must be (or what kind of offer in compromise it will accept). The IRS expects you to keep a minimal lifestyle until the tax debt is paid off. Expenses for private schools, trips to Hawaii, or champagne-and-caviar grocery bills aren't tolerated.

Don't underestimate your family's living expenses—list where every penny goes every month. Write in the “comments” section on the CIS if your expenses will increase in the near future (a baby is on the way, your car needs a new transmission, and so on). If your income is likely to decrease, your spouse is about to be laid off, or one of your major customers has declared bankruptcy, mention that as well. Paint it black.

Actions the Tax Collector Can Take

Entrepreneurs are natural-born optimists. Typically, when small business owners get behind on their bills—including taxes—they believe that things will turn around any day.

IRS collectors, however, are born pessimists. They want their money now, not a pie in the sky. If you don't pay, the IRS will ask for a list of everyone who owes you money (your business's accounts receivable) and the name of your bank.

This gives the IRS a road map for places to go to seize assets—which can force you out of business real fast.

After analyzing your finances, a revenue officer can proceed in one (or more) of the following ways:

- demand immediate payment of the full amount if the officer believes you can pay without much difficulty
- ask you to apply for a loan from at least two financial institutions
- ask you to sell any assets not currently used in your business, or personal items the officer considers extravagant—for example, a second home or a pleasure boat
- propose an IRS installment agreement allowing monthly payments
- suggest you submit an offer in compromise to settle the tax bill for less than the balance due
- begin enforced collection against your business—and maybe personal—assets; this means seizing bank accounts, accounts receivable, equipment, and other things you own
- report your file as “currently not collectible,” if not enough assets or income can be located for even a nominal payment.



TIP

The IRS sometimes suspends collection efforts. Even the IRS has heard about getting blood from turnips. In IRS lingo, this is called “53-ing” a case—a collector can submit IRS Form 53 to his or her superiors. If approved, IRS collection efforts are suspended, but interest and penalties continue to mount.

Suspension doesn't last forever—every six to 18 months, the IRS computer may bring up your account. You may be contacted and asked to update your financial situation. If you rejoin the ranks of the employed while on 53 status, the IRS expects you to notify them—but they won't find out automatically.

Regardless of which course the IRS collector pursues, he or she she will demand that—if your business is still operating—you stay current on all required tax filings. These include personal income tax returns and business payroll tax returns (if you have employees). If you have income from your sole proprietorship, limited liability company, or partnership, you must make quarterly estimated tax payments as well. Furnish evidence that these filings are current to the IRS.



TIP

If you don't pay payroll taxes, your business is in jeopardy. The IRS will shut down a business with employees if it's not making current payroll tax deposits. You may be allowed to keep your doors open if you owe past-due payroll taxes, but only if you keep current on new taxes (and if you agree to a payment plan for the old ones).

Will the IRS Close Down Your Business?

Revenue officers will pressure you into coming up with money to pay your back taxes. But their bark is often worse than their bite. In fact, at the IRS, padlocking the doors of a delinquent taxpayer's business is considered an admission of failure, not a badge of honor. It doesn't usually result in revenue for the government, because auction sales of business equipment typically don't bring much in—often not enough to cover the costs of seizing, storing, advertising, and selling the items. Realistically, a shutdown is unlikely because it is simply too much trouble and paperwork—except when you owe payroll taxes for the current quarter.

Cooperating With the Collector

IRS collectors typically ask where you bank and for a list of the business's accounts receivable.

The IRS can use this information to start seizing income.

While lying to any IRS employee is a crime, not answering questions is legal. If you don't provide financial data, the IRS won't beat you with rubber hoses.

The worst that can happen is that an IRS collector may issue a summons—a legally enforceable order requiring you to appear and provide information under oath. If a collector issues a summons, it usually means she or he suspects you of hiding assets.

Never ignore an IRS summons. This could get you hauled in front of a federal judge and jailed. If you have few assets, you probably have little to lose by cooperating. If you have a lot to lose, talk to a tax attorney before answering a summons.

Dealing With a Monster Tax Bill

Sad to say, lots of people have huge tax bills and little hope of ever being able to pay.

EXAMPLE: The Smiths' computer store is faced with a new deep-discounting competitor across the street. Trying to keep their business afloat, the Smiths run up \$800,000 in debts—including \$300,000 to the IRS for payroll taxes—before calling it quits. Sam Smith goes to work as a salesperson, earning \$25,000 per year, and Jeannie Smith now earns \$15,000 a year as a part-time bank teller. The Smiths' combined earnings are less than the annual IRS interest and penalties on their \$300,000 tax bill. Even if they cut expenses to the bone, they will probably never be able to pay off their tax bill. What should the Smiths do? Hint: The answer is not move to Brazil.

Take heart—there are ways to reduce or even eliminate gargantuan tax bills. One way is the offer in compromise. For some folks, another solution is bankruptcy. Let's look at both possibilities.

The Offer in Compromise

Under its Offer in Compromise program, the IRS sometimes will negotiate a settlement for less than the balance owed. (Internal Revenue Manual § 57(10)1, IRC § 7122.) For example, in 1994, after hounding country singer Willie Nelson since 1980, the IRS accepted a final compromise settlement of \$9 million on a \$32 million tax bill. The IRS accepts many offers in compromise that are properly submitted and not too outlandish.

Don't think that the IRS takes the forgiving of any tax debt lightly. It will accept less only if it is doubtful more will be collected later. To get the IRS to accept an offer in compromise, you must demonstrate to the IRS that it's in its—not your—best interests.

There is an IRS filing fee for making an offer, unless you are indigent. And, in most cases, a partial payment of 20% of the tax debt must be made with the offer filing.

An offer in compromise must be made on IRS Form 656. It must be accompanied by a completed IRS Form 433-A (individual) and, if you have a separate business entity, Form 433-B (business). (These are the financial disclosure forms used in all IRS collection situations.)

You'll be asked to provide verification of your finances—such as bank statements for the past three to 12 months, living expense receipts, vehicle titles, mortgage notes, rental and lease agreements, and a list of outstanding debts.

EXAMPLE: The Smiths, whose failed computer business left them with \$300,000 in tax debts, make an offer in compromise. They give a Form 433-A and documentation to verify their poor financial state. After losing most of their assets to creditors, the Smiths' financial form is relatively simple. Form 433-B is not necessary, because the Smiths are no longer in business and now have jobs earning minimum wage. They offer the IRS \$25,000, to be provided by Jeannie's mother. Will the IRS

accept this? I think the Smiths have a good shot.



RESOURCE

Recommended reading. For details on how to present a successful offer to the IRS, see *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

Bankruptcy

In 2005, Congress drastically revised the bankruptcy code. Bankruptcy is now much more difficult to qualify for. Go to Nolo's bankruptcy area at www.nolo.com for books and information on this topic and get help from an experienced bankruptcy attorney if you are considering filing for bankruptcy.

When the IRS Can Take Your Assets

If you and the IRS don't agree on a repayment plan and you don't file for bankruptcy, you face what the IRS calls enforced collection. This usually means a tax lien and levy.

Federal Tax Liens

If you owe a tax bill, the IRS may record a notice of federal tax lien in the public records in your county. (IRC § 6323(f).)

A recorded lien shows the world, or at least anyone who bothers to look, that you have a federal tax debt and the amount originally owed. Lien notices are often reported in local newspapers and business publications. Credit bureaus collect tax lien information for credit reports.

The IRS may record a tax lien if you owe a past-due tax bill and don't agree to pay it off within a year. The IRS doesn't always file a tax lien; it is hit or miss. Whenever you are dealing with

a collector, request that the IRS not file a lien. Once recorded, it is very difficult to get a tax lien released without making full payment to the IRS.

A tax lien is a claim against all of your assets, much like a mortgage on real estate. A tax lien is the kiss of death to your ability to borrow money, unless the funds will go directly to the IRS.

Congress grants the IRS the right to take just about anything you own to satisfy a tax lien. Lenders will shun you, and others may fear that the IRS might grab their money or goods in your possession.

Federal Tax Levies: Seizing Assets

A tax lien doesn't take any of your assets—a tax levy does. A levy occurs when the IRS physically seizes your assets to satisfy a tax debt. The IRS may grab something directly (such as your office equipment), or it may make a written demand to someone holding your assets (your bank, for example). A levy may follow closely behind a tax lien notice, or happen without a tax lien being filed, or it may never happen at all.

Seizures are most likely when you ignore a tax bill. When you hear about the IRS padlocking a business, you can bet it didn't come out of the blue. The IRS first warns the owner in writing of its intent to levy.

Once the IRS has your assets, it is not easy to get them back. You'll need to show it's in the IRS's best interest to release them. For instance, you might get back an essential business asset if losing it means you will have to close your doors, and thus be deprived of any means to pay your tax debt.

EXAMPLE: Harry, owner of Pavco, a road contracting business, owes \$75,000 in back payroll taxes. The IRS seizes his paving trucks, effectively putting Harry out of business. Harry offers to pay \$10,000 per month for the next five months if the IRS will release the trucks. With his trucks back, Harry can

stay in business. The IRS may go for this deal. Otherwise, an IRS collector will auction off Harry's trucks to pay Pavco's tax debts.

What the IRS can take

The IRS usually seizes bank accounts first, because it just takes the push of a button. A computer-generated levy form is sent to any financial institution that the IRS even suspects holds your money.

The next most popular IRS target is your wages—even if due from your own corporation. And if you are self-employed and have received payments (reported on Form 1099), the IRS may send levy notices to the payors.

The IRS can also intercept any money owed you for goods or services. And tax refunds from the IRS or states are taken automatically. In addition, if a tax collector can find it, an officer can grab money or property held for you by relatives or friends.

Most anything you own is subject to IRS levy, including your residence—no matter what your state homestead laws provide—as well as your pension plans. Thankfully, the IRS does not aggressively go after homes and retirement plans because of the political heat and bad publicity generated. The IRS wants to be perceived as tough, but not heartless. The IRS won't usually levy until it has tried, and failed, to get you to agree to make a payment plan, sell your assets, or take other positive steps to deal with your tax debt.



TIP

It can make sense to stonewall an IRS request for information, at least in the short term. Never lie to an IRS collector about anything, but you may want to be tight-lipped. Say something like, "I intend to pay the money I owe as soon as possible. I take my debt seriously and am sincerely trying to get the necessary funds. I'm sorry, but for my own peace

of mind, I can't divulge private information about my bank accounts or other assets." The collector won't be overjoyed, but she won't throw you in chains, either. Use the time to plan on how to deal with your tax problem. The IRS isn't going to go away.

What the IRS cannot take

Some of your assets are exempt from IRS seizure by law. The IRS won't take the shirt off your back or the clothes in your closet. Unfortunately, the assets that are protected have fairly low dollar values.

Generally, the IRS can't touch your family's wardrobe, personal effects, tools of your trade, or a portion of your wages (as determined by IRS tables) (IRC § 6334(a)). The levy exemption tables are revised annually for cost of living increases.

EXAMPLE: Brian and Wynona, a married couple with two small children, had a retail seafood business that failed. They are now working for Wal-Mart. If they don't negotiate a deal with the IRS to pay back taxes—such as a payment plan—and the IRS levies their wages, they'll be allowed to keep only about \$438 per week, total. The balance goes to the IRS. But unless the couple owns valuable assets (a race car, vacation home, boats, or the like), the IRS is highly unlikely to seize any of their personal property.

Before seizing assets from your business premises, the IRS will ask for your permission. If you refuse, the IRS can legally remove things only from the public areas of the business, such as the cash drawer, furniture, and equipment. However, the IRS must get a court order to seize

anything in nonpublic areas, like the back office and storeroom.

The IRS cannot come into your home to seize assets, unless you agree or the officer has a court order. The IRS rarely seeks court orders.

EXAMPLE: The IRS levies on Ling Wo's Chinese restaurant's assets. It can empty out the cash register, but can't remove the woks from the kitchen—unless Ling Wo agrees or the IRS has a court order.

Getting Liens and Levies Released

To release a recorded tax lien, the IRS wants something in return. A typical scenario for small business folks is when they find a buyer for their business assets. Typically the IRS won't approve the transfer free of the tax lien unless it is being paid in full or gets the proceeds of the sale. The collector must also be convinced that the assets are being sold for their fair market value. Sales to relatives are a red flag and may be disallowed.

EXAMPLE: Valjean, who runs a motorcycle repair shop as a sole proprietorship, owes a \$40,000 tax audit bill. The IRS collector threatens to shut his operation down and auction off the contents of the shop. Booger, Valjean's mechanic, offers to buy the shop's tools and equipment for \$20,000. To get the IRS to go along with the sale and release the tax lien, Valjean must convince the IRS collector that \$20,000 is the fair market value of the assets. Valjean won't get any money from the sale, but will get a \$20,000 reduction of his tax bill.

When You Can't Pay Your Taxes in a Nutshell

- The IRS has the power to seize your assets if you don't pay a tax bill.
- The IRS can't take your home without a court order, but it can take most of your wages and bank accounts.
- A tax lien can be recorded in the public records if you don't pay a tax bill after written demand from the IRS.
- You don't have to disclose to an IRS collector where your assets are located, but you cannot actively conceal them.
- It is a crime to lie to an IRS officer about your tax liability or assets.
- The IRS can shut a business down for nonpayment of payroll taxes.
- Usually the IRS will allow you to pay old tax bills in installments over months or years, but interest and penalty charges keep running.
- It is difficult, but possible, to reduce a tax bill with the IRS using its Offer in Compromise program.
- A bankruptcy judge has the power to reduce or eliminate a tax bill through a Chapter 7 or 13 proceeding.

Resources

- IRS Publication 594, *Understanding the Collection Process*. This is a short, relatively clearly written pamphlet.
- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book discusses solving IRS collection problems in greater detail than is given in this chapter. It also contains many useful forms for dealing with the IRS.
- *The New Bankruptcy: Will It Work For You?*, by Robin Leonard (Nolo). This book explains bankruptcy alternatives and how to handle your own Chapter 7 bankruptcy case.
- *Chapter 13 Bankruptcy: Keep Your Property & Repay Debts Over Time*, by Robin Leonard (Nolo). This book explains how to use Chapter 13 of the bankruptcy code to pay off your tax debts.
- Bobby Covic (EA), one of the most knowledgeable tax pros I know in this area of practice, is available for telephone consultations on tax collection matters. He can be reached at 775-831-7694 or P.O. Box 6206, Incline Village, NV 89450.

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“It is not the thief who is hanged, but one who was caught stealing.”

— H. L. Mencken

An audit is an IRS examination of you and your business as well as of your tax return. The IRS’s goal is to verify that your tax return accurately reflects your income and tax deductible expenses. Besides looking at your records, auditors make subjective decisions about your honesty.

As a small business owner, you are four times more likely to be audited than wage earners. Odds are, if you stay in business very long, you’ll be audited at least once. And if irregularities are ever found, audit lightning is likely to strike again. Indeed, a few small-time operators are audited every year or two.



RESOURCE

Recommended reading. How to prepare for, avoid, and defend yourself in an audit is covered in detail in *Stand Up to the IRS*, by Frederick W. Daily (Nolo). The fraud and criminal chapters there may be of interest as well. If you’re facing an audit, it is an invaluable resource.

Who Gets Audited?

Audit victims are seldom selected randomly. In fact, small businesses and their owners are pulled from the IRS audit hopper in several very deliberate ways, discussed next.

Computer Picks

Computer scoring is the most likely way a small business becomes an audit candidate. An IRS computer program, known as the DIF scoring process, scans every Form 1040 and assigns it a numerical grade. The highest scores, roughly 10% of all individual tax returns, are human-reviewed for audit potential.

Sole proprietors’ returns are audited the most. At least 80% of small businesses are sole proprietorships whose owners report their business income on Schedule C of their Form 1040 individual tax returns.

Business partnerships, LLCs, and small business corporations all file returns, too. However, the audit rate of these entities is about half that of sole proprietorships.

How the DIF program works is a highly guarded IRS secret, but here is what former IRS employees have told me. The most important scoring factor is the *ratios* of a business’s income to various types of its expenses. For instance, if the IRS computer data shows restaurants in your area average food costs as 32% of gross sales, and yours claims 55%, you will get a higher DIF score. However, it usually takes more than just one item to get you audited.

Market Segment Specialization Programs

Every year the IRS targets certain businesses, professions, and industries for audit. These campaigns are called industry specialization or market segment specialization programs. Recent victims range from funeral home operators, car dealers, and attorneys, to airline pilots and plastic surgeons.

The IRS zeroes in on certain businesses when experience has shown a high degree of non-compliance with the tax laws. For instance, an IRS study of attorneys found that criminal and immigration lawyers were less likely to report all of their income than other attorneys. Another study found that airline pilots were prone to investing in questionable tax shelters. And, the IRS reasons that lawyers, pilots, and other high earners are the ones most likely to be able to pay audit bills.

Informants’ Tips

Tips to the IRS—from disgruntled former business associates, employees, or ex-spouses—can trigger

an audit. But don't be overly concerned about your enemies' list. The IRS knows that many tips result from spite and may not be accurate, so only 2% of all audits come from tip-offs. Anonymous tips are usually ignored altogether.

However, if other people know things—you're keeping two sets of books, paying your house painter with a business check, or skimming cash from the till—be at least a little worried. Today's bookkeeper can become tomorrow's tax squeal, particularly if that person can document your tax cheating to the IRS.

Follow-Up Audits

Audits of other individuals or businesses can bring the IRS to your door. For instance, if one of your business partners gets audited, you may be next.

If you have your finger in many pies, you may be hit with a package audit of all your enterprises: corporations, investment groups, and trusts. The IRS looks askance at people who operate in myriad business forms, suspecting income may be shifted or hidden among the entities.

Prior Audits

If you were audited once and flunked, your odds of a return visit go up greatly. People caught claiming phony tax deductions or not reporting income are likely to try it again, the IRS reasons.

On the other hand, some people lose audits badly, yet never hear from the IRS again. The IRS audit machine operates in a hit-or-miss fashion.

Criminal Investigations

Law enforcement and IRS criminal investigations can lead to an audit. For instance, when a police agency makes an arrest and finds a lot of cash in someone's possession, it may contact the IRS. Similarly, folks charged with embezzlement or drug dealing may be brought to the IRS's

attention. However, the information flow between law enforcement agencies and the IRS is very spotty.

Amended Returns and Refund Claims

What about filing amended tax returns—for example, if you later discover an overlooked deduction? Generally, you have 36 months after the original due date of the return to amend it to lower your tax liability. (Use Form 1040X.) While the IRS may reject any amended tax return, it usually accepts them.

Many people file amended returns to get a refund. And, as you most surely know, the IRS is not in business to give money back. So, not surprisingly, the audit likelihood for amended returns is higher. If an amended return is audited, the original tax return—not just the items amended—is opened up for inspection.

Computer-Generated IRS Bills and Adjustments

The IRS often sends computerized notices when it finds a suspected problem with your individual or business tax return. The notice may appear to be a bill. For instance, the IRS may claim you forgot to report \$400 in interest from your savings account. The notice further states how much additional tax you owe—on the assumption that the IRS is correct, and you're wrong.

This letter is an IRS "automated adjustment notice," usually designated as a CP-2000 letter. If the IRS is right—you did forget the \$400 interest—then consider it a bill.

But if the IRS computer is wrong—you really did report the \$400 on your return, but listed it under dividends instead of interest—call and mail a letter with documentation to the IRS. Make sure to send a copy of the notice you received.

Filing Extensions

If you can't file your individual tax return on time, you should file IRS Form 4868. This gives you an additional six months to file. There is no evidence that filing for an extension increases your audit chances. If anything, it might lower your risk.

How Long Do You Have to Worry About an Audit?

Generally, a tax return can't be audited after 36 months from the date it was filed. Note that this time limit (called a statute of limitations) starts to run only when you actually file a tax return. Years in which you never file a tax return are open to IRS scrutiny forever.

Most audit notices are sent by first class mail between 12 to 18 months after you file your tax return. Typically, if you haven't heard from the IRS within 18 months, you won't be audited.

Exceptions to the three-year rule. Some circumstances give the IRS more time to audit:

- If you understate your income by at least 25% on a tax return, the audit deadline is extended to six years.
- If you file a fraudulent tax return, there is no time limit. Tax fraud, as explained below, is more than just a little fudging. The IRS rarely tries to audit anyone after six years, even if fraud is suspected.

Deadlines. Once an audit is started, the Internal Revenue Manual directs it to be wrapped up within 28 months—beginning on the date you filed your tax return. The 28-month cutoff is an internal rule to give the IRS time for potential appeals processing after an audit and still end it within the 36-month time limit. (See Chapter 21.)

Bottom line. These statutory and internal IRS time limits mean the auditor is under pressure to close out your audit file. So, the older an audit case gets, the more anxious the IRS is to bring it

to a conclusion. The auditor can close a case more easily if you agree and sign the audit report; the auditor's job performance is partially judged on getting your agreement. Knowing this opens up the possibility of negotiating.

How the IRS Audits Small Businesses

The IRS audits small businesses and their owners by correspondence, office audits, and field audits. The difference is not only where the audit is held, but the intensity of the process.

Office and Correspondence Audits

If your sole proprietorship takes in less than \$100,000 per year, the IRS may ask you to mail in documents or come to its local office. Usually, only one year's tax return is selected for an office audit. Just as it sounds, you go to the IRS offices with your records (see below for what you must bring) and meet with a tax examiner for a few hours.

Field Audits

With a partnership, limited liability company, corporation, or sole proprietorship with gross annual receipts over \$100,000, the audit is usually held outside the IRS office. Called a field audit, this process is much more intensive than an office or correspondence audit.

Field auditors are called revenue agents, and are much better trained in accounting than IRS office tax auditors.

In recent years, the average adjustments for a field audit—meaning additional tax, penalty, and interest assessed—total over \$17,000. The IRS may devote as much as 40 hours (including time to write a report) to a field audit of a small business.

**TIP**

Conduct your audit away from your business premises. You have the right to keep an IRS field auditor away from your business premises if his or her presence would interfere with your operation. You can demand that the audit be held elsewhere—at the IRS office or, if you have a tax pro represent you, at the tax pro's office.

My advice is to hold the audit elsewhere, even if it is not an inconvenience. Otherwise, the auditor can observe your operation and form an opinion as to whether it is more successful than your tax return indicates. Or, the auditor might question your employees and get the wrong ideas.

EXAMPLE: An IRS auditor sees a picture of a beach house on the desk of Benny, owner of Benny's Burgers. Since he reported only \$15,000 to \$20,000 in income for the past six years, the auditor asks how he can afford this luxury item. If Benny can't explain (like an inheritance from a rich uncle), the auditor will look hard for evidence of unreported income.

Another reason to hold the audit off your premises is that you have better control of the situation. If the auditor asks to see additional records, they may be back at the business. Since digging up documents slows things down, the auditor may drop the request. And even if you'll have to produce the documents later, the delay gives you a chance to edit out material the auditor is not entitled to see—like data from years that are not under audit.

**CAUTION**

Auditors look for personal expenses disguised as business deductions. With small businesses, the IRS auditor is ever on the lookout for people who bury personal expenses in their business. Cars, travel, and entertainment are often targets. In these areas, particularly, it pays to keep good records.

Your Audit Rights—The Taxpayer Bill of Rights

To stem IRS abuses, Congress passed a Taxpayer Bill of Rights. This law is explained in IRS Publication 1, *Your Rights as a Taxpayer* (available by calling 800-829-1040 or at www.irs.gov). It summarizes your rights during any (noncriminal) IRS proceeding, including audits, appeals, and collections, including your right to:

- have a say in the time and place of the audit
- hire a representative to meet with the auditor instead of going yourself
- audio record IRS meetings, and
- speak with an IRS employee's manager if you are being treated unfairly.

The Auditor's Powers

Forget about being innocent until proven guilty. The tax law specifically places the burden of proof on you to back up what is in your tax return. Proving the correctness to an auditor may not be all that easy. The IRS wins over 80% of all audits, often because people can't verify data on their returns. Poor record keeping—not outright cheating—is the downfall of most audit victims.

Never forget that it's your job to prove to the IRS auditor the accuracy of your tax return, what lawyers call the burden of proof. It is not up to the IRS to disprove anything. Typically, this means verifying expense deductions claimed on your tax return. For instance, can you produce an invoice showing that you incurred the expense? Can you prove that you paid it with a cash receipt, check, or credit card statement? Can you show it was business related?

EXAMPLE: An auditor challenges a \$300 deduction that Ethan, owner of Ethan's Travel Service, took as a business entertainment expense. Ethan first proves he incurred the

expense—he didn’t just make it up. He shows his monthly Visa statement and his canceled check to Visa. Next, Ethan shows notations written on the charge slip and in his business diary that the expense was for taking Harry, a longtime customer, out to dinner at the Ritz-Carlton. They discussed a worldwide cruise for Harry’s honeymoon. This satisfies the auditor that Ethan was entitled to claim this expense as a business deduction.

Congress gives the IRS broad, but not unlimited, powers in auditing. The IRS, in the course of an audit, may do any of the following:

- inspect your business premises
- view your home office
- scrutinize your records, or
- summon records held by others.

Let’s look more closely at each of these.

Inspecting Business Premises

Even though you can insist the audit be held outside your business (see above), the IRS may enter your premises if they’re open to the public.

However, the auditor cannot go into your business’s private area, such as a storeroom or office, unless invited. But, just because you can keep the IRS out of these areas doesn’t necessarily mean that you should. If you have nothing to hide, then don’t just be obstinate—it may arouse their imaginations. Give agents a guided tour rather than let them wander around on their own.

Viewing Home Offices

You don’t have to let an auditor into your home without a court order (very rare to have one). If you claimed a home office deduction on your tax return, photographs and diagrams of the business space will satisfy most auditors.

Occasionally, though, auditors request to inspect home offices. If you don’t allow it, the auditor will probably disallow your home office

depreciation or rental expense because you haven’t verified its existence. Remember, the burden of proving deductions taken on a tax return is always on you.

Scrutinizing Your Records

Whether the audit is at the IRS office, your place of business, or your tax pro’s office, the auditor will expect to see records. If they are on a computer, he or she will ask for a printout, plus check registers, bank statements, canceled checks, receipts, and invoices. If you keep a formal set of books, you must show those as well.

If you don’t produce something requested, the auditor may give you a written request with a date to comply. If still not satisfied, the auditor can issue a summons to you (just like the third-party summons discussed in the next section).

In the end, if you never come up with acceptable records, the auditor can create his or her own figures—meaning that some or all deductions will be disallowed and/or unreported income may be added.



SEE AN EXPERT

Do your records contain a smoking gun?

If something incriminating is hiding in your records, you may withhold them by claiming your constitutional right against self-incrimination. This is a judgment call that should be discussed with an attorney, not with your accountant.

Summoning Records Held by Others

An auditor can get records from your tax preparer, banks, suppliers, customers, and others by using a third-party summons. An auditor won’t issue a summons without first attempting to get this information directly from you, for example, by asking you for bank statements and canceled

checks or invoices. Usually, you should be cooperative, as these are things an auditor can get with a third-party summons anyway. If in doubt, see a tax pro.

Should You Get Audit Help?

If you have good reason to fear an upcoming audit, such as tax fraud, consult a tax attorney well before meeting the auditor.

Tax Fraud and How to Avoid It

Careless mistakes, or even overstating a deduction on a tax return, is not tax fraud. Fraud is roughly defined as a deliberate attempt to evade taxes. To put your mind at rest, tax fraud is charged in less than 5% of all audits. Nevertheless, a fraud penalty of 75% can be tacked on to any tax found owing. And, where the fraud covers three or more years (found in less than 1% of all audits), the IRS may call in its Criminal Investigation Division.

If you have major skeletons in your tax closet—income you didn't report or phony business deductions—see a tax attorney before the audit starts.

For an office or correspondence audit, hiring a tax pro may be a waste of money. It is okay to go it alone if your records are good and you have nothing to hide.

For a field audit, consider bringing in a tax pro from the get-go, because:

- Field audits produce much larger tax bills (on average four times greater) than do office audits. So it's a lot easier to justify the expense of a tax pro. And, the fees are tax deductible.
- The IRS field auditors are better trained than office auditors. So it's more likely that you will be outmatched if questions come up about documents or tax law.

- If you hire a representative, the field audit can be conducted at his or her office—not yours.



SEE AN EXPERT

If you are worried about tax fraud, always bring in a tax attorney. An authorized representative must be an attorney, a Certified Public Accountant (CPA), an Enrolled Agent (EA), or the preparer of the tax return in question, and must have your written power of attorney (IRS Form 2848). For more information, see Chapter 23.

Tax attorneys and CPAs are the most expensive (expect to pay \$125 to \$400 per hour for their time). Enrolled Agents charge about \$50 to \$150 per hour. Professional time for a small business field audit ranges from ten to 50 hours. You do the math.

By law, you may take anyone with you to an audit that you like. Your tax preparer or bookkeeper can explain the business receipts and records. Or you can bring along a friend to lend moral support.

You do not have to personally attend an audit, in most cases. There is no legal requirement that you ever have to meet the auditor—unless the auditor issues a summons to you. Keeping out of the picture means that there is no possibility of your giving damaging answers to the auditor's questions.

Bookkeepers, managers, or any other employee with knowledge of the business's tax affairs can go to the audit instead of the owner. But if you don't want to show your face, it's best to have your attorney, CPA, or EA show up for you.

These tax pros speak the same language as the auditor and may even have dealt with the person before and have an idea of what makes him or her tick. Also, if tough questions are raised, a tax pro can say, "I don't know, let me check with my client." This may cause the auditor to adjourn the audit so you and the pro can talk things over.

Perhaps most important of all, a seasoned tax pro can spot problem areas—for example, expenses on which you didn't keep good records, or ones that look more like personal, than business, deductions.

Preparing for Your Audit

Before meeting the auditor, thoroughly review the tax returns being audited. Be ready to explain how you—or a tax return preparer—came up with the figures. If you can't, ask your tax preparer or another tax pro.

Pinpoint problems backing up income sources or expense deductions. Research tax law, if necessary. You'll need to legally show your right to take tax deductions or other tax benefits claimed on your return.

Find all records that substantiate your tax return. The IRS has a right to look at any records you used to prepare your tax return. Organize your records for the auditor in a logical fashion.

Preaudit organization of receipts, checks, and other items refreshes your recollection for the audit meeting.



TIP

Neatness counts. Forget about dumping a pile of receipts on the table and telling the auditor to go at it. Messy records mean more digging, and the more gold the IRS expects to mine. Auditors reward good record keepers by giving these folks the benefit of the doubt if any problems arise. Neatness builds your credibility even if you are not really all that honest. (Order appeals to an accountant's mentality.)

What to Bring to an Audit

Audit success means documenting your expenses. Be prepared to show that your tax return is based on good business records. Proof should be in

writing, though auditors are authorized to accept oral explanations.

A list of items the auditor wants to see accompanies your audit notice. At a minimum, the IRS will expect you to produce the following documents:

- **Bank statements, canceled checks, and receipts.**

The auditor will want to see bank records—both personal and business—from *all* of your accounts. As a rule, don't discard any business-related canceled checks or invoices or sales slips. If you paid some expenses with cash, keep the paperwork (handwritten notes, receipts, or petty cash vouchers) showing the payments.

- **Your books and records.** The auditor will ask to see your books. As explained in Chapter 4, small businesses don't have to keep a formal set of books; don't let an auditor tell you otherwise. Records can be just a bank statement, checkbook, or cash register tapes. If you maintain more formal records—such as ledgers and journals—the auditor is entitled to see them. If your data is on computer, the auditor will want to see a printout.

- **Electronic records.** Many banks don't return canceled checks anymore, and many business expenses are charged on credit or debit cards. Bank and charge card (Visa, MasterCard, American Express) statements are accepted by the IRS as proof of payment. They must show the name, date, amount, and address of the payee.

But, because charges, slips, and monthly statements don't show the business nature of the expense, you can't rely on them as your only records.



CAUTION

Don't make the IRS guess. If you don't produce adequate records, the auditor is legally permitted to estimate your income and/or expenses—

plus impose a separate penalty for your failure to keep records. Don't expect the auditor to be a generous estimator.

- **Appointment books, logs, and diaries.**

Businesses that offer services typically track activities and expenses using calendars, diaries, appointment books, or logs. An entry in a business diary helps justify an expense to an auditor—as long as it appears credible.

You must keep special records for certain equipment, called listed property, if used for both business and pleasure. (IRC § 280F.) (See Chapter 4.)

Computers kept at home (but used for business), cellular phones, and vehicles used for both business and pleasure are tax-termed as listed property. Purely business equipment is not listed property—for example, mechanic's tools, a lathe, or a carpet loom—so no records of usage are required.

When assets are susceptible to both business and personal use, the auditor can demand records of usage.

EXAMPLE: Tina uses her computer for business email and to shop on eBay. She should keep track of the business portion of her use. One way is with a note pad next to the computer. To a great extent, Tina is on the honor system.

If she hasn't kept usage records, she can reconstruct them by memory or notes.

- **Auto records.** A vehicle you use for business is listed property if used for personal purposes. This dual-purpose use requires records showing the work portion. A log is the best way to keep track but is not strictly required

by the tax code. (See “Vehicle Expenses” in Chapter 2 for a sample log.)

Alternatively, keep all gas and repair receipts with notations of trips showing when the car was used for business. Or, add up the gas bills and divide by the number of miles per gallon that your car averages. Show the auditor your auto trip receipts and explain how they link up to your business diary. A day-timer or calendar notations help back up your deduction.

- **Travel and entertainment records.** By law, out-of-town business travel and entertainment expenses (T & E, in auditor lingo) require greater record keeping than most other expenses.

You must have a written record of the specific business purpose of each travel or entertainment expense, as well as a receipt for it. (IRC § 267.)



TIP

Carry an appointment book or diary. A good way to document T & E expenses is with a day-timer, calendar, or appointment book, noting each time you incur a business expense, and the reason.

Most people aren't disciplined enough to write down every expense as it is incurred. It is okay to reconstruct records after you have received an audit notice. But be up front about it—don't insult the auditor's intelligence by trying to pass off wet-inked paper as an old record. Remember, it's key to develop and maintain credibility with the auditor.

EXAMPLE 1: Bianca, a self-employed interior designer, reconstructs a calendar book with a notation for June 18, 2011, as follows, “Round-trip cab fare to office of John Johnson, prospective

client—\$14 (no receipt). Lunch at Circle Restaurant. Discuss proposal to decorate new offices at 333 Pine Street—\$32 (Visa charge) plus cash tip of \$6 (no receipt).” The auditor will probably be satisfied, or may ask Bianca a few questions.

EXAMPLE 2: Sam (the owner of the computer store) went to an out-of-town computer retailers’ convention. He spent \$1,800 and claimed it as business travel expenses on his tax return. On audit, Sam produces charge card statements to prove the \$1,800 was spent for hotels, meals, and convention registration. The auditor asks Sam to justify the business purpose of this trip. Sam produces a program for the convention. If it looks legitimate, and Sam’s explanation of why it was important for him to be there is convincing, the auditor should allow the deduction in full.

- **Expenses for renting or buying property.** Prove rental expenses with a copy of the lease, or if you didn’t have a lease, with canceled checks or signed receipts. If you bought the property or equipment, bring in the purchase contract or receipts, or other proof of purchase. These documents establish grounds for claiming these expenses as well as a beginning tax basis of the property for depreciation deductions.

Don’t Rush a Field Audit

Most people want to get an audit over with as quickly as possible. With an office audit this may not be a bad idea, but with a field audit, faster isn’t always better.

Slowing down an audit often works to your advantage. Extra time to get records together or

delaying for any other plausible reason is both permissible and wise.

The older an audit file gets, the more anxious the IRS is to close it out, for several reasons. Auditors are facing the statute of limitations, discussed above, which gives the IRS only three years to audit you. Also, the IRS has internal rules requiring an audit to be completed within 28 months after a return is filed. After an auditor is finished, the report must be processed, reviewed, and formally approved, all of which eats up time. So, an auditor is under time pressure to close your case.

Making the auditor watch the calendar isn’t the only reason to delay. Since you never can be too well prepared for an audit, it often makes sense to ask for extensions of time. Most people need time to dig out papers from the recesses of their garage and put them in order, or to contact their bank to get missing copies of checks or statements. After getting it all together, you may need to run it by a tax pro. Assuming you work for a living, this project takes a lot of your spare time to do right.

Also, events like your annual family reunion may be set at the time the audit is scheduled, or you may become ill, are in your business’s Christmas season, or have some other excuse for a delay. If you need a postponement, call the auditor. In most cases, the appointment will be reset for a month or two later.

What Auditors Look for When Examining a Business

First and foremost, the IRS training manual tells its auditors that they are examining you, not just your tax return.

The auditor wants to see how you match up with the income reported on your return—economic reality in IRS-speak. If your business is audited, the IRS will likely want to know:

What You Need to Prove Certain Business Expenses				
	Expense			
	Travel	Entertainment	Gift	Transportation (Car)
Amount	Amount of each separate expense for travel, lodging, and meals. Incidental, smaller expenses may be totaled in categories such as taxis, daily meals, long distance calls, and so on.	Amount of each separate expense. <i>Note:</i> The IRS is strict about records of entertainment expenses.	Cost of gift.	Amount of each separate expense, including: • cost of the car • mileage for each business use of the car, and • total miles for the tax year.
Date	Date you left and returned for each trip, and number of days for business.	Date of entertainment. For meals or entertainment directly before or after a business discussion, the date and duration of the discussion.	Date of gift.	Date of the car expense or use.
Place	Name of city or other destination.	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. Place where business discussion was held if entertainment is directly before or after a business discussion.	N/A	Name of city or other destination if applicable.
Description	N/A	N/A	Description of gift.	N/A
Business Purpose	Business reason for travel or the business benefit gained or expected to be gained.	Business reason or the business benefit gained or expected to be gained. Nature of business discussion or activity.	Business reason for giving the gift or the business benefit gained or expected to be gained.	Business reason for the expense or use of the car.
Business Relationship	N/A	Occupations or other information—such as names or other designations—about persons entertained that shows their business relationship to you. If all people entertained did not take part in business discussion, identify those who did. You must also prove that you or your employee was present if entertainment was a business meal.	Occupation or other information—such as name or other designation—about recipient that shows his or her business relationship to you.	N/A

What to Do About Missing Documents

Myth: Every deduction must be proven, or it won't be allowed.

Fact: Courts say that taxpayers can't be expected to keep perfect records. If your tax documentation is incomplete (which is often the case with small business owners), don't despair. You are required to demonstrate to the IRS only that you are in substantial compliance with the tax laws.

The substantial compliance rule means you can try any of the following when you don't have original documentation:

- offer oral explanations to auditors in place of missing records
- reconstruct records, or
- approximate expenses.

EXAMPLE: Elijah produced a small music festival and rented tents from a traveling carnival company, which insisted on payment in cash. Elijah lost the receipt for the payment of \$800, and the carnies moved on to parts unknown. Elijah can reconstruct this receipt with his oral explanation, a picture of the tents from the local paper, and a letter from a ticket taker who saw him make the \$800 cash payment.

The auditor also asked to see Elijah's office utility bills for the year under audit. Elijah could come up with only nine months of bills, and the utility company could not provide duplicates

because its computer broke down. Elijah can approximate the missing expense data by averaging out the other nine months of bills.

Even if you can't figure out a way to document an expense, recreate your own paperwork and tell the auditor this is what you have done. For instance, write a repair receipt with the name and address of the person who did the work, the date, and amount paid.

For missing items, you may invoke the *Cohan* rule for expenses other than travel and entertainment. A court case (*Cohan v. Commissioner of the Internal Revenue*, 39 F.2d 540 (2d Cir. 1930)) allowed George M. ("Give my regards to Broadway") Cohan to approximate his business expenses in an IRS audit. The case stands for the proposition that estimations of business expenses are acceptable—as long as it is reasonable to believe that some amount was spent, and there is a good reason why records are not available. Typical excuses are that records were lost or destroyed, or the transactions were not the type that receipts are normally given for, such as cab fares or tips.

If less than \$75, a business-related travel or entertainment expense doesn't require substantiation, as long as it is believable to the auditor and not excessive under the circumstances. (Regulation 1.274-5T.)

- **Did you report all of your business sales or receipts?** If you know that you “forgot” to report significant business income—\$10,000 or more—strongly consider hiring a tax attorney to handle the audit. Remove yourself from the process altogether. If the auditor finds this kind of unreported income, and it looks intentional, he or she may call in the IRS criminal investigation team. However, if there is a plausible explanation (“someone must have forgotten to record September’s sales”), then don’t worry about the IRS cops. The auditor will probably just assess the additional tax you should have paid in the first place, plus interest and a 20% penalty for your error.
 - **Did you write off personal living costs as business expenses?** The IRS knows that every small-time operator has likely claimed a personal expense as a business one. For little things—a few personal long distance calls on the business telephone line—the IRS won’t get too excited. But if you deducted \$2,000 in repairs on your motor home during a trip to Yellowstone, an auditor may figure this out by looking at your credit card statements—and disallow it, with a penalty added.
 - **Does your lifestyle square with your reported income?** An auditor sizes you up for dress style, jewelry, car, and furnishings in your home or office, if given a chance to make these observations. Someone who looks like a Vegas high roller, with a tax return of a missionary, will cause any auditor to dig deeper.
 - **Did you take cash—or otherwise divert income into your own pocket—without declaring it?** Auditors naturally suspect skimming if your business handles a lot of cash. (See “Cash Transactions Catch the IRS’s Attention,” below.)
 - **Did you write off personal vehicle expenses as business expense?** Personal use of your business set of wheels is so common that auditors expect to find it. That doesn’t mean they will accept it, however. Auditors don’t believe you use your one-and-only vehicle 100% for business and never to run to the grocery store or the dentist. If you drive for both business and pleasure and claim a high percentage of business usage, keep good records—preferably a mileage log.
 - **Did you claim personal entertainment, meals, or vacation costs as business expenses?** Travel and entertainment business expenses are another area where the IRS knows it can strike gold. Document all travel and entertainment deductions. Taking friends to the ball game and calling it business won’t fly if you can’t show a business relationship.
 - **If you have employees, are you filing payroll tax returns and making tax deposits?** Employment taxes are a routine part of every audit of a small enterprise. See “Employment Classification: A Hot Issue,” below, and Chapter 6.
 - **If you hire people you call independent contractors, are they really employees?** Again, see “Employment Classification: A Hot Issue,” below, and Chapter 6.
- This list is by no means complete—these are just the most likely things an IRS auditor looks for.

Employment Classification: A Hot Issue

Auditors are on the lookout for employees misclassified as independent contractors. Once the IRS raises this issue, it’s up to you to prove that the workers were truly independent contractors. The IRS auditor may talk to the people in question if they can be found.

So far, we know that unreported income, poor business record keeping, and mixing business and personal use of property are obvious IRS audit concerns. Let's next focus on areas in which your tax returns are most vulnerable.

Cash Transactions Catch the IRS's Attention

The IRS is suspicious of all businesses that are inherently cash intensive. Bars, game arcades, restaurants, minimarts, pawnshops, and laundromats are frequent audit targets. So are waiters, car dealers, cab drivers, gambling industry workers, bellhops, and immigration lawyers.

If yours is a predominantly cash operation, an IRS auditor will be particularly interested in your lifestyle. Sports cars, rental property, vacation homes, boats, and low reported income could mean an intense audit or, worse, an IRS criminal investigation.

All businesses—including financial institutions—must report transactions of cash over \$10,000. Not just greenbacks, but also cash equivalents—traveler's checks, money orders, and bank drafts—must be reported to the IRS on Form 8300. Personal checks of any amount are not within the cash reporting requirement. While aimed at money launderers and drug dealers, this law applies to legitimate businesspersons, too.

Structuring a transaction to avoid this law—say, making three cash deposits of \$4,000 on three different days—is also required to be reported on Form 8300. Penalties for not following cash reporting rules range from fines to audits and even jail. (See IRS Publication 1544, *Reporting Cash Payments of Over \$10,000*, for details and a copy of Form 8300.)

This law doesn't apply to nonbusiness cash transactions. So, for instance, a parent giving a child more than \$12,000 in cash doesn't have to file Form 8300. (But there is a federal gift tax filing requirement.)

The Income Probe

The number one issue auditors are trained to sniff out in business audits is unreported income—especially if your operation is cash-intensive (see “Cash Transactions Catch the IRS's Attention,” above). Expect an auditor to start with the income probe. Anticipate questions like, “Did you report all of your income?” Another favorite is, “Do you keep a lot of cash around?” Don't conclude that big brother IRS has secret knowledge here. Auditors ask everyone these questions. This puts you on the defensive early in the game.

Bank Deposit Analysis

This brings us to bank deposit analysis. Office auditors seldom do this, but field auditors routinely add up all your bank deposits to see if the total is more than your reported income. Auditors also ask to see all of your personal bank account records to check that the deposits are consistent with your business receipts.

If you don't produce bank records voluntarily, the auditor will likely get them from your bank. If you cover up bank accounts, or otherwise lie to the auditor, you risk being investigated for tax evasion.



TIP

Audit your bank accounts in advance.

Do your own bank deposit analysis before the audit. If deposits exceed the income reported, be ready with explanations. Don't invent sources; many deposits aren't taxable income. Loans, sales of assets (only the gain, if any, is taxed), transfers from other accounts, inheritances, and money held for relatives are among many explanations.

Is It a Legitimate Business Expense?

Next, the auditors move on to verifying business expenses. Remember, you must prove that

deductions were for profit-making purposes; it's not up to the IRS to disprove them. Any expense may be questioned, but certain ones are IRS favorites:

- travel and entertainment (see Chapter 2 and discussion above)
- home office (see Chapter 14)
- asset purchases (see Chapter 3), and
- auto expenses (see Chapter 2).

Review these chapters for the rules on deductibility to see if you are on firm ground before the audit begins.

How to Behave at an Audit

The Internal Revenue Manual says the first taxpayer interview is the most important phase of an audit. Whether you handle this interview or have a tax pro go for you, remember that both you and your business are under the microscope. Take a tip from Shakespeare and be true to thine own self. If you lay bricks for a living, don't try to act or look like a lawyer, and vice versa. Here are some other words of advice.

Keep Chit-Chat to a Minimum

Talking with the auditor about the weather or football is okay, but avoid rattling on about your business and personal affairs. Because audits are so stressful, many of us cover our nervousness by talking. IRS auditors rely on this natural tendency and listen for clues or admissions. For instance, don't fill in a silence by remarking how jet lagged you are from a trip to Bora Bora, or the auditor may wonder how you can afford it. After all, he or she may earn about the same as you say you do, but can't manage airfare to Omaha. Don't be surprised if the person asks point blank how you manage money so well. It doesn't hurt to ask the auditor some questions back—to take the focus off you.

Without your telling them, auditors know very little about you before the meeting. Your

auditor will have the tax return under audit and a printout of all W-2s and 1099s if you're required to report wages and certain financial transactions. The auditor's file may also include a listing of real estate and vehicles registered in your name. But that's it. They won't even have your other years' tax returns, although they may have some computer data for two more years.



CAUTION

Don't lie about what you do. The IRS knows how you make a living because it's on your tax return. (Occupations must be stated both in plain English and by listing a four-digit code on 1040 forms.) It is a crime to misstate the nature of your business on a tax return—a prostitute was once convicted of tax fraud for telling the IRS she was in public relations.

Answer Questions Concisely

When the auditor asks a direct question, the preferred comeback is "Yes" or "No." Resist the temptation to overexplain, ramble on, or answer questions that weren't asked.

If you are in doubt, say, "I don't know," or "I'll get back to you on that," or "I'll have to check my records," or "I'll ask my accountant." The auditor may let it go. If he or she doesn't, at least you've slowed the process down, usually to your advantage.

EXAMPLE: The auditor asks Sue what percentage of sales in her Clothes Horse boutique were for cash. Sue doesn't keep separate figures for cash sales apart from credit card and check sales. Sue might make a fairly accurate guess, or she could go into a long explanation of how most customers pay for clothes with credit cards or checks. But, why should Sue risk giving an answer that may be wrong or misinterpreted by an auditor? Sue should simply say, "I have no idea because I

don't keep those kinds of records." Or, "If you give me time, I can review my records and get back to you."

It's Okay to Ask for Time Out

You may recess an audit for any good reason—a bathroom or lunch break, maybe for the day if you feel ill or need to confer with a tax attorney or your CPA. IRS Publication 1, *Your Rights as a Taxpayer*, states your right to get tax advice or bring in a representative at any time. If you are in over your head, are confused, or can't answer a question, firmly tell the auditor that you need a recess. Auditors are tightly scheduled and may not have time to meet again soon. Use the delay to consider your next step.

Don't Be Hostile or Phony

What about trying to charm the auditor with your wonderful personality or good looks? Up to a point, this is fine. All rumors to the contrary notwithstanding, auditors are human. The IRS also gives its auditors wide latitude; a lot of judgment calls are made. If you are pleasant and run an honest looking business, you may get the benefit of the doubt if the auditor uncovers problems. Conversely, if you come in radiating hostility, you are daring the auditor to reciprocate. Nevertheless, don't try too hard to ingratiate yourself. This can backfire too.

Complain If the Auditor Is Abusive

Most auditors are straightforward and professional, but a few delight in giving taxpayers a hard time. You may run into an auditor who is impolite, hostile, or downright nasty.

The Taxpayer Bill of Rights entitles you to courtesy from the IRS. Remind the auditor of

this and ask the person politely to lighten up if he or she is noticeably hostile. If the behavior persists, tell the person you are too upset and want to call off the audit for the day. Or say that you want to consult a tax pro before going further, another privilege in the Taxpayer Bill of Rights. Threatening this can reform an auditor's attitude, because they are under time pressure. Or demand to speak with the person's manager. If all else fails, simply walk out. Send a tax pro to the next appointment in your place, or appeal the audit result. (See Chapter 21.)



CAUTION

Never offer favors to an auditor. If the audit is at your place, it's fine to give an agent a Coke or a cup of coffee. Don't go beyond that, whether it is lunch or a small discount at your store. All perceived bribery attempts (or threats, for that matter) are reported and can result in an especially thorough audit, if not a criminal investigation.

How to Negotiate With an Auditor

Despite IRS claims that auditors can't negotiate, give-and-take is common. An auditor's job performance is judged largely based on how many cases they close marked "agreed." Auditors want you to consent to their findings and not appeal or go to tax court. So the auditor is told to get your consent. This gives you negotiating power. It doesn't mean auditors want your signature so badly they will allow bogus business expenses or overlook unreported income. But it does give the auditor incentive to negotiate. Here are some negotiating strategies.

Don't Just Sit There

Keep asking the auditor about disallowances he or she is considering as the audit progresses.

Otherwise, you will be in the dark until you get the examination report. Don't let an auditor take the easy way out—make the person face you and justify the decisions. In turn, you can argue your position right then and there. Or if the auditor plans to make an adjustment because you didn't produce records, you can ask for time to find or reconstruct the documents.

EXAMPLE 1: The auditor tells Sue, owner of the Clothes Horse boutique, that she is disallowing a \$400 expense paid to Helena, a fashion consultant. Sue produces a canceled check but hasn't produced anything else showing the nature of Helena's services. Sue could ask for time to get a statement from Helena describing the work, and bring or mail it to the auditor.

EXAMPLE 2: The auditor isn't convinced that it was necessary for Paul to buy a \$40,000 airplane for his plumbing subcontracting business. Paul could get a letter from Morgan, the general contractor who hired him, saying that he hired Paul to work a project in a remote area inaccessible by car.

EXAMPLE 3: The auditor tells Barbara, a direct mail consultant, that she is disallowing her deduction for the theft of a computer. Her reason is that there is no documentation of the loss. Barbara could get a copy of the police report for the auditor.

Talk Percentages, Not Dollars

Auditors don't talk about the dollars you will owe from an audit, but they will discuss percentage adjustments. For instance, your auditor wants to disallow a \$500 deduction. Don't reply, "Would you take \$300?"

Instead, talk in terms of percentages, based on whether the adjustment should be made in the

first place. Although this amounts to the same thing, adjustment percentages, not dollars, are the language of IRS auditors.

Or let's say you lost all paperwork for an \$820 office supply deduction. The auditor proposes to disallow 100% of the deduction. You could counter along these lines: "Since I made a decent profit and maintained an office, I must have bought office supplies. I lost the receipts, but my reconstruction of expenses is reasonable. I should be allowed at least 50%."

EXAMPLE: Bertha is a part-time wedding consultant with a small downtown office. At an audit, Bertha was asked to produce paperwork showing she paid \$932 in cash for parking at a nearby garage. Bertha didn't bother to keep parking receipts. The auditor says, "No deduction." Bertha could counter by saying, "You know that I live 12 miles away and there is no public transportation to my office, so I must have driven, and there is no street parking. However, I will agree to your disallowing 25% of parking expenses just to get it over with."



TIP

Keep in mind the difference between arguing and negotiating. When you argue, you are usually disputing an auditor's conclusion ("It was really a deductible business trip!"). By contrast, negotiating is the art of meeting in the middle. ("The trip was for both business and pleasure, so how about agreeing that 70% of expenses were deductible for business and 30% nondeductible for nonbusiness?")

Arguing Issues

Most audit issues fall into two broad categories: verification and justification. So far we have focused on verification problems, such as lost paperwork. In the previous example, the auditor

didn't question Bertha's right to claim a parking expense, but whether it was verifiable.

A justification issue, on the other hand, arises if the auditor questions whether Bertha's wedding consulting really was a profit-seeking business—or if it was a social pastime. If primarily for pleasure, Bertha wasn't entitled to claim any parking expense. (See “Hobby or Business?” in Chapter 14 for a discussion of why a hobby is not a business for tax purposes.)

Unlike verification issues, justification or legal issues (such as whether or not your corporation is valid) may require a tax pro. If a legal issue comes up, ask the auditor for time to do some research or confer with a tax pro.

Adjustments in Your Favor—Taking the Offensive

An audit is not a one-way street. The Internal Revenue Manual says auditors must make adjustments in your favor whenever errors are found. Even the most hard-nosed auditor knows that people occasionally make mistakes in the IRS's favor or overlook claiming tax benefits on their returns.

This is another good reason to go over your return and records with a fine-toothed comb before the audit. If you find any missed deductions or if you were too conservative—for instance, you didn't take a deduction for entertainment because you were afraid of raising an audit flag—then bring it up at the end of the audit. You no longer have anything to lose.



TIP

Bring up items in your favor after the auditor has completed the review. Psychologically, it's better not to raise anything in your favor until after the auditor has decided on all adjustments against you. If you bring them up earlier, the auditor may look harder for offsetting items. But if you wait until after

the decisions are made, he or she has no choice but to consider your positive change items.

Don't Try to Negotiate Based on Inability to Pay

The worst way to negotiate is by telling an auditor you can't afford the bill, simply throwing yourself on the auditor's mercy. *Whether you ever pay the tax bill from the audit is not the auditor's concern. Their job is to audit you.* After the audit is finished, the job is done and your case goes to the IRS Collection Division, a completely separate department.



TIP

Take heart—there are ways to reduce audit bills. It may be possible to lower an audit bill that is beyond your ability to pay by using the IRS Offer in Compromise procedure. Alternatively, if things are really bad, your debt may qualify for reduction or discharge in the bankruptcy law. Or, you can usually get an installment payment plan. (See Chapter 19.)

Your Options After Getting an Audit Report

After the auditor is finished, you will be handed or mailed an IRS examination report. The IRS considers the audit completed, but the report may still be modified if you act quickly enough.

You have three choices after getting the report.

Agree

You may throw in the towel by signing the report. Then it's all over, and generally speaking you can't change your mind. If tax is due, you will get a bill with interest and penalty (if any) included. The audit report is not officially a tax bill. The final bill

is issued by the IRS a month or two after the IRS audit file is closed.



TIP

Check your bill. Sometimes, statements from the IRS differ from those given by auditors. Don't ask me why; it just happens. If the bill is for more than the auditor's report, complain to the IRS. If less, then you may have lucked out.

Argue

Examination reports aren't chiseled in stone. If you don't think a report is fair, call the auditor and say why. If the auditor can't be persuaded, ask to speak to his or her manager. *Don't be shy—you have rights as a taxpayer. Take the problem over the auditor's head.*

The manager does not have to meet with you, but he or she will let you make your case on the phone. Tell the person where you think the auditor missed the boat. Politely let the manager know that you will continue to fight (see next chapter on how to do this). You don't have anything to lose by trying.

EXAMPLE: Phil, a full-time college professor and part-time jazz musician at small clubs on weekends, is audited. The IRS disallows Phil's expenses for piano lessons of \$675 and opera singing lessons of \$290. (The auditor couldn't see how these lessons were business-related, since Phil is a drummer.) Phil calls the auditor's manager and explains that both types of lessons enhance his musical abilities. He offers to accept disallowance of the opera lessons (\$290) if the IRS allows the piano lessons (\$675) deduction. The manager agrees to the compromise and the report is changed.

Getting an Audit Payment Plan

The audit is over and you (reluctantly) agree with the IRS that you owe some money. Naturally, your thoughts turn to how you are going to pay. The auditor may ask if you can pay on the spot. If you can't, he or she will offer to help you set up a payment plan.

You don't have to discuss payment at all with an auditor; it's optional. You can wait until you are contacted by the IRS collection division, but the IRS interest meter is running.

If you want to pay the IRS in installments, your request usually will be granted, if all of the following are true:

- the total owed is under \$10,000
- all of your tax returns due have been filed, and
- all current year's tax payments are made (such as quarterly estimated taxes for self-employed people).

If you owe more than \$10,000, the auditor may process the forms to request an installment agreement, but it is up to the collection division to grant or deny the request.

It's okay not to commit to pay at the end of an audit. You may need time to think it over, or ask a relative for a loan, or whatever. Your case will simply be shipped off to your IRS Service Center for billing.

Do Nothing

Eventually, IRS audit reports become final—with or without your signature. However, the IRS may sit on your case for several months before formally closing the case. If you really have no points to negotiate or money to pay, choose the do-nothing option. This delays your final audit bill—but remember that interest is mounting.

When Your Audit Is Final

When the audit is finished, the IRS will mail a letter advising you of your right to either:

- appeal within 30 days (see the next chapter on how to appeal an audit), or
- contest the audit in the U.S. Tax Court within 90 days of the date of the letter to stop the audit from being finalized. (See Chapter 21.)

Audits in a Nutshell

- The IRS has the power to audit anyone who has filed a tax return, but is most likely to audit a self-employed individual.
- The normal period of worry about an audit is within three years following the filing of your tax return.
- A computer scoring process is responsible for most audits.
- It is up to you to convince the IRS auditor that you reported all of your income and were entitled to all deductions on your tax return.
- If you have lost your records and receipts, it is permissible to reconstruct them for an audit.
- It's advisable to keep the IRS from holding an audit at your place of business.
- Delaying or prolonging an audit typically works in your favor.
- By hiring a tax pro, you don't have to meet an auditor face to face.
- Don't expect to come out of an audit without owing something.
- Complain to an auditor's manager if you are being treated unfairly.
- If you are worried about serious tax fraud being discovered in your audit, consult a tax attorney before speaking to the IRS.

Resources

- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This self-help book discusses IRS audit, appeal, and tax court strategies in more detail than covered here.
- IRS Publication 1, *Your Rights as a Taxpayer*. This pamphlet is clearly written and is a must-read for all taxpayers.
- *Surviving an IRS Tax Audit*, by Frederick W. Daily (Nolo).
- IRS Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

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“Nor shall any person ... be deprived of life, liberty or property, without due process of law.”

— Fifth Amendment,
Constitution of the United States

You don’t have to accept an IRS bill. In most instances, you can appeal it within the IRS. Or, you can go to federal tax court before paying the bill. (IRC §§ 9011, 9041.) An audit appeal is simple to initiate, and for small tax court cases—under \$50,000—you can do it without a lawyer.

IRS statistics reveal that 85% of taxpayers who appeal get their bill reduced! The average appeals settlement produces a 40% reduction. Many people do even better. And even if you don’t win your appeal, you will have delayed the final tax bill for many months.



RESOURCE

Recommended reading. Appealing an audit is discussed in much greater detail in *Stand Up to the IRS*, by Frederick W. Daily (Nolo).

IRS Appeals

If you don’t sign off on an auditor’s examination report, in most cases the IRS mails you a 30-day letter. This is your invitation to go to the IRS Appeals Office, which is completely separate from the audit division. Until and unless this letter is received, you cannot appeal (but you don’t have to pay the audit bill, either).

The IRS is not required by law to let you internally appeal an audit, and sometimes it doesn’t. But don’t worry—the IRS must always notify you in writing of your right to contest the audit in the U.S. Tax Court.

Writing an Appeal Letter

An appeal is begun by writing a protest letter to the IRS. (If you owe less than \$2,500, you can simply tell the auditor that you want to appeal; but play it safe and put it in writing.) A sample protest letter is shown below. It should include:

- your name (or the name of your business, depending on which one the audit report specifies) and your taxpayer identification number (either your Social Security number, if you are a sole proprietor without employees, or federal employer identification number)
- a statement that you are appealing an examination report
- the specific findings in the report that you dispute—something like this: “I disagree with the auditor’s disallowance of business expense for travel in the amount of \$797,” or “I disagree with the finding by the auditor that my dog obedience business was not carried on for profit.”
- a brief explanation of why the report is wrong—for example, “The trip in question was necessary to see a potential customer who lived in South Dakota,” or, “I operated in a businesslike manner and trained many dogs to be responsible members of the community.”
- your signature, date, and these magic words: “Under penalty of perjury, I declare that the facts presented in this protest and in any accompanying documents are, to the best of my knowledge and belief, true, correct, and complete.”

Attach a copy of the examination report and the 30-day letter from the IRS. Send the letter to the IRS office that audited you, addressed to the “District Director.” Your letter will be processed and forwarded to the IRS Appeals Office.

Sample Protest Letter

October 1, 20xx

District Director
Internal Revenue Service
Your Town, Your State 99999

Protest of Sam Smith
SSN 666-66-6666

Dear Sir/Madam:

I wish to appeal the examination report of 9/5/20xx, a copy of which is attached. I request a hearing. The tax year protested is 20xx.

I disagree with the disallowance of business expense deductions shown on Schedule C of \$13,937 and penalties and interest in the amount of \$2,817.

The adjustments were incorrect because the deductions were for legitimate expenses of advertising, promotion, travel, and entertainment and were reasonable and necessary for my business.

Under penalty of perjury, I declare that the facts presented in this protest and in any accompanying documents are, to the best of my knowledge and belief, true, correct, and complete.

Sincerely,
Sam Smith
Sam Smith

cc: IRS auditor

Enclosed: Copy of IRS 30-day letter
Examination Report

in explanations, copies of documents, citations to legal authority, affidavits of witnesses, or whatever else you believe supports your position. A tax pro can help put things together if you are unsure.

If the appeals officer phones to discuss your case and you are ready, go ahead. A better idea is to request a later time to talk when you can be fully prepared. If you have a lot of documents to present, or feel that you could do a better job in person, then insist on a meeting. Most things go better when done face to face, but maybe you are more comfortable at a distance.



SEE AN EXPERT

It's time to consult a tax pro. Even if you handle your IRS appeal yourself, consider seeing a tax pro for some advice. A good one can offer insights on what went wrong at the audit and how to prepare your appeal in a professional manner. Appeals officers appreciate a well-organized presentation and will often reward you with a favorable settlement. The same advice applies to contesting an audit in tax court (see below.)

The Appeals Hearing

If you don't get anywhere with an appeals officer by phone or mail, ask for a face-to-face meeting. Some IRS offices don't have appeals officers, so you may have to travel to another city.

Your hearing will probably be one on one with the appeals officer in his or her office. Auditors or other IRS personnel seldom attend. No formal or electronic recordings of appeals hearings are made. It's okay for you to take notes, as will the officer.

Most people find appeals officers easier to deal with than auditors. They work for the IRS but are not there to just rubber-stamp auditors' decisions. Their aim is to mediate a settlement so you won't go to court. Use this second chance to sell your position that your tax return was correct—or closer to it than the auditor's report says.

Settling Without a Hearing

Within a few months after requesting an appeal, you'll get a call or a letter from the IRS Appeals Office asking you to come for a meeting. Or an appeals officer may offer to handle the case just by phone or correspondence. This is worth a try. Send

Winning your audit appeal. Expect an appeal hearing to last an hour or two. Start with a brief explanation of why you think the examination report is wrong. Show any papers supporting your position. Emphasize any material you didn't have at the audit, such as new documents or a reconstruction of lost items. If something's still missing, explain why.

Convince the appeals officer that you have some chance—no matter how small—of winning in court. However, an appeals officer can't make a purely nuisance settlement—that is, give in just so you will go away. Some evidence—even if only substitute records to replace missing ones—can provide the appeals officer with a hook on which to override the auditor. (Chapter 20 explains how reconstructed records can be used.)

Almost any kind of auditor's adjustment is fair game for appeals negotiation. Common small business appeal issues include entitlements to a home office deduction, travel and entertainment expenses, and advertising and business car write-offs.

Making a deal on appeal is often done by trading issues. Get the appeals officer to see that you have an arguable point on at least one issue and you are willing to concede on another issue.

Don't expect total victory in an appeal, although it is certainly possible. It's better to stay flexible; give-and-take is the proper attitude.

EXAMPLE: Rusty is an independent building materials sales rep. He regularly calls on customers in his car and wines and dines his larger accounts. But an IRS auditor disallows Rusty's auto expenses of \$1,740 as well as his business entertainment expenses of \$820, due to spotty record keeping and missing receipts.

Rusty argues to the appeals officer that he needs his car to make calls and that it is customary for salespersons in his business to buy customers lunch or take them to baseball games. Although Rusty lost his receipts,

he can back up his claims with signed statements from customers he's entertained. Rusty offers to trade issues by accepting the disallowance of the entertainment expenses if the appeals officer allows his automobile expense deduction, or offers to accept a 50% disallowance of each.



TIP

Mention your tax court option.

If the appeals officer is not amenable to any kind of settlement, state politely that your next stop is tax court. If the officer thinks you are serious, he or she may make a last ditch effort to work things out.

Payment After an Appeals Settlement

If and when you reach a settlement, appeals officers will request—but cannot insist on—immediate payment of any tax due. They can also process a monthly payment plan request. However, an appeals officer is not supposed to make any settlement conditioned on your immediate payment or acceptance of a payment plan.

Contesting an Audit in Court

You aren't required to go through the IRS appeals process before going to court. If you don't appeal—or do but aren't happy with the way it comes out—you can go to one of three courts: United States Tax Court, United States District Court, or the Court of Federal Claims.

Almost everyone chooses tax court, for two good reasons: First, the district and claims courts require you to first pay the tax and then sue for a refund. Second, few people succeed in the latter two courts without lawyers.

Tax court, on the other hand, allows you to contest an audit for a filing fee of \$60 and offers a reasonable chance of success without a lawyer.

About Tax Court

The U.S. Tax Court is an independent federal court, not part of the IRS. (IRC §§ 7441-46.) Contesting an audit in tax court requires filing a one-page form petition, for a small case. (See below.)

The chances of at least partial victory are good: Over half of those filing in tax court either settle with the IRS lawyers before trial or get some reduction in court. For instance, the judge may uphold the IRS on a tax adjustment, but knock off all penalties.

In cases under \$50,000, 47% of taxpayers win at least partial victories over the IRS auditor. In larger cases, 60% of taxpayers come out ahead! However, fewer than 10% win a total victory in tax court.

Can You Do It Yourself in Tax Court?

Whether or not you want to go it alone in tax court should depend on how much money is at stake. Most tax court disputes involve factual issues—not complex tax law points. Many individuals without law degrees or accounting backgrounds often come out just fine representing themselves in tax court.

Under \$50,000: informal “S” cases

Disputes of less than \$50,000 (per tax year audited) are treated under rules much like a small claims court. These “S,” or small case, procedures are informal. You simply present your case to a judge in your own words.

Over \$50,000: regular cases

Regular cases (more than \$50,000 per year is in dispute) require a lawyer. (A small number of CPAs and Enrolled Agents are also approved to practice in tax court.) If you go in solo (without a lawyer), the judge will expect you to know tax law and court procedures. A compromise solution may be to use a tax lawyer as a legal coach, but who doesn’t appear in court. Some tax court judges are tolerant of *pro se* petitioners (people representing themselves), but others may give you short shrift for not knowing your tax law.



TIP

Filing a petition is a wise move. Often, just filing a tax court case produces a settlement. If not, you can always chicken out before going into court, and you’ll only be out the \$60 filing fee. Alternatively, you can file and try to settle the case yourself, bringing in a lawyer only if you fail. At the very least, your petition delays the final tax bill (although the interest continues to run).

Filing Your Petition in Tax Court

To go to tax court, you must have first received an IRS Statutory Notice of Deficiency, also called a 90-day letter. Expect this letter within one to six months after your audit, assuming you did not agree to the examination report. The notice is sent by certified or registered mail. If you move during this time, make sure the IRS has your new address. (File Form 8822, *Change of Address*.)

To find out how to file a small case with the tax court (under \$50,000 per year), call or write to:

Clerk of the U.S. Tax Court
400 Second Street, NW
Washington, DC 20217
202-606-8754

or go to the tax court’s website at:
www.ustaxcourt.gov/faq.htm.

Request or download a petition form and a pamphlet explaining the court's small case rules. If you request the information by mail, the tax court will get these items to you within a few days. Don't expect any advice on winning your case from the clerk, however.

Carefully follow the instructions for filling in the forms. Mail the petition (preferably via U.S. Postal Service, certified mail, return receipt requested). Enclose your check or money order for the filing fee. You'll get an acknowledgment letter and case number from the tax court in about a week. The clerk sends the IRS attorneys a copy of your petition. You are on your way! The next move belongs to the IRS.

Tax Court Pretrial Procedure

Within a few months, you'll hear from the IRS, either from an appeals officer or a lawyer. This is an important contact, since most tax court cases are settled by that person without going to court. You might even negotiate a deal by phone or through the mail without ever meeting anyone. (See the discussion in "IRS Appeals," above, on how to negotiate an appeal.)

If no compromise is reached, you'll get a notice of a trial date, which comes six to 12 months after you file. Trials are held in about 100 U.S. cities. You may have to travel several hundred miles to court—another reason to settle before trial.

Settling Before Trial

IRS lawyers frequently agree to last-minute deals—even in the hallway outside the courtroom—minutes before your trial is to begin. If they don't try, you should. Try something new—such as agreeing to some adjustment that you previously did not accept. Fewer than 10% of all people get a total victory in a tax court trial, so be realistic.

EXAMPLE: Karen's auto parts business was audited, and additional taxes of \$5,100 were found, including \$1,300 for disallowed business expenses. Karen could offer to accept \$1,300 in taxes if the IRS will concede the other issues and wipe out the remaining \$3,800. This might be accepted by the IRS attorney or, more likely, bring a counteroffer. In any case, it doesn't cost Karen anything to try.

If you reach a settlement, a stipulated tax court decision is prepared for your signature. It is sent to the IRS and then to a judge for approval. It takes a few months to complete the paperwork, so don't be concerned if you don't get anything back right away. (The only thing to worry about now is paying the bill.)

Your Tax Court Trial

How your trial will be conducted may depend on whether you qualify for the simplified tax court procedures for small cases (less than \$50,000 contested per tax year) or as a regular case.

All cases

On the date you are scheduled for trial, show up early. Typically, many other IRS victims will be there, and the clerk will start by calling roll. Chances are your case won't be heard on that day; more likely you'll be assigned a time and date later in that week (or the next one) for trial.

The judge sits on a wooden throne (as on TV), or at the end of a conference table if there is no formal courtroom. Once your case is called, come forward and sit at a table facing the judge. The IRS attorney will be at another table.

Bring all papers you want the judge to see. If you have witnesses, have them sitting nearby. Address the judge as "Your Honor."

The judge won't know any facts of your case. He or she has only your petition, the IRS's response (called an answer), and a copy of the

audit report. The judge does not have the IRS's file or any of the documents that you submitted to the auditor or appeals officer. You are starting with a clean slate.

You and your witnesses will be sworn to tell the truth. You may sit or stand, according to the instruction of the judge, as you present your case. A table will be provided for you to lay out your documents and sit at while the IRS attorney is presenting his case.

Presenting your case. Start by asking the judge if you can give a brief explanation of why you disagree with the IRS, but don't go into the details just yet. Next, either ask permission to start calling your witnesses or begin by presenting your documents (whatever you want the judge to consider). Important: Bring an extra copy of everything you give the judge for the IRS's attorney—and don't forget to keep originals.

Explain the significance of each document, even if it seems obvious. For instance, "Your Honor, this is a bill from Jake, the plumber who fixed the pipes, which the IRS auditor would not allow as a business expense deduction."

Expect the judge and the IRS attorney to ask you questions. The whole thing is relatively informal, especially if yours is an S case. Speak and show documents as if you were trying to convince a friend that you are right and the IRS is wrong.

EXAMPLE: Thom's Hardware store was damaged by a flood. Thom quickly hired Jim, an out-of-town handyman, to make emergency repairs. Jim insisted on payment of \$3,800 in cash. Thom got a receipt from Jim for payment but lost it in the confusion. Jim is now in parts unknown after his parole officer came looking for him. An IRS auditor disallowed the \$3,800 deduction—not because this type of expense was not legally allowed, but because Thom couldn't prove payment. So Thom's dispute with the IRS is over the factual issue of whether he paid

\$3,800—not whether it's a legitimate business expense.

At the tax court hearing, Thom starts by explaining what happened in his own words. Thom brings in a witness, Deena, who observed the flood damage and saw Jim do the work. Even though Deena didn't see Thom pay Jim, she can tell the judge that Thom needed help fast, and that Jim worked seven full days. The judge can easily infer that Jim didn't work without pay.

Thom also shows the judge a news clipping and photos of the flooded store. It is up to the judge to determine if Thom, Deena, and the documentation are believable enough to overturn the auditor's findings.



TIP

Watch and learn. On the day of your trial, there may be other cases heard before yours. You may find it enlightening (or stupefying) to spend a few hours watching and learning about the judge's habits and courtroom procedures firsthand.

Cases over \$50,000 only

If the IRS claims you owe more than \$50,000 per tax year, you must be familiar with tax law and tax court procedures if you hope to win. Start by consulting the books listed at the end of this chapter, or bring in a tax lawyer.

Tax Court Decisions

Unlike Judge Judy, who wraps it all up in 15 minutes and rules on the spot, tax court judges usually mail out their decisions a few weeks or months after a trial.

Small case tax court decisions (under \$50,000) are final; they cannot be appealed by you or by the IRS.

Regular tax court decisions (cases over \$50,000) may be appealed to the U.S. Court of Appeals.

Appealing a tax court decision is expensive and requires an attorney. Fewer than 15% of all tax court decisions are reversed.

Assuming you don't win outright, it will be several months after receiving the judge's decision before you get a tax bill. Interest is added to the bill starting from the time the original tax return was filed—or the date it should have been filed, if earlier.

Appealing IRS Audits in a Nutshell

- If you can't live with an IRS audit report, appeal within the IRS.
- The majority of IRS appeals result in at least some tax reduction.
- You always have the right to contest your audit in the U.S. Tax Court.
- Appealing delays the audit bill, but penalties and interest keep running.
- Prepare for an appeal by carefully organizing your records, researching basic tax law, and perhaps consulting a tax pro.
- Going to tax court is simple if you are contesting less than \$50,000 for one audit year.

Resources

- IRS Publication 1, *Your Rights as a Taxpayer*.
- IRS Publication 5, *Appeal Rights and Preparation of Unagreed Cases*.
- IRS Publication 556, *Examination of Returns, Appeal Rights and Claims for Refund*.
- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This companion book has detailed information and tips on handling appeals and tax court cases.
- *Represent Yourself in Court*, by Paul Bergman and Sara J. Berman (Nolo). This book is full of practical tips on how to present documents to a court and what to say (and not to say) to a judge.
- *Rules of Practice and Procedure*, United States Tax Court. If you are handling a tax court case on your own, you must familiarize yourself with the rules of court. This free booklet is available through the Tax Court Clerk, 400 Second Street, NW, Washington, DC 20217, 202-606-8754. These rules are also available on the U.S. Tax Court's website, www.ustaxcourt.gov, and in most federal court buildings and law school libraries.

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“Laws and institutions require to be adapted, not to good men, but to bad.”

— John Stuart Mill

When the IRS hits you or your business with a tax bill, it usually adds penalties and interest. These extra charges can be shocking—an old \$7,000 tax bill could have \$15,000 in penalties and interest tacked on to it.

Some penalties, such as for late payments, are added automatically by IRS computers. Or, IRS personnel may impose penalties if you violated a tax code provision, such as filing a return late. The IRS doesn't just dream up penalties—each one has been authorized by our elected representatives in Washington.

Once penalties are decreed, if you don't complain, the IRS assumes you accept them. Happily, the IRS can remove a penalty just as easily as it added one. The key to the kingdom of tax penalty relief is showing a reasonable cause for your failure to comply with tax law.

Tax penalties are not tax deductible for individuals.

Common Reasons for Penalties

The number of different tax code penalties is staggering. This section covers only the penalties most likely to be imposed on a small business owner.

Inaccuracies

The IRS can hit you with a 20% penalty if you were negligent (unreasonably careless) or substantially understated your taxes. This accuracy-related penalty is applied when you can't prove a deduction in an audit, or you didn't report all of your income and the IRS discovers it.

Civil Fraud

If the IRS finds that you underreported your income with a fraudulent intent (it doesn't look like an honest mistake to the IRS), a fine of 75% can be added. (IRC § 6651(f).) Breathe easy—this civil (noncriminal) tax fraud penalty is imposed in fewer than 2% of all audits. (You may also be charged with the crime of tax fraud, which is even rarer.) (IRC § 7201.)

Late Payment

The IRS usually adds a penalty from ¼% to 1% per month to an income tax bill that's not paid on time. This late payment penalty is automatically tacked on by the IRS computer whenever you file a return without paying the balance owed, or when you pay it late. (IRC § 6651(a).)

Penalties for failing to make payroll tax deposits on time are much higher.

Late Filing

If you're late in filing required forms, the IRS can penalize you an additional 5% per month on any balance due. However, this penalty can be applied only for the first five months following the return's due date, up to a 25% maximum charge. If there is no balance due, the IRS can still tack on lesser penalties.

An extension to file your tax return does not extend your time to pay any taxes due.

Filing and Paying Late

A special rule applies if you both file late and underpay. The IRS can (and probably will) impose a combined penalty of 25% of the amount owed if not paid in the first five months after the return and tax are due. After five months, the failure to pay penalty continues at ½% per month until the two penalties reach a combined maximum of 47½%. This is a slightly lower (2½% less overall)

penalty than if the two penalties were applied separately. (IRC § 6651(c).) Wow, those IRS folks sure can be generous.

EXAMPLE: Mortimer the mortician lets April 15th pass without filing his tax return or making any payment. He finally gets around to filing on September 16th and owes \$4,000. The IRS will tack on a 25% penalty (\$1,000), bringing the bill up to \$5,000. Interest will be charged as well. In recent years, the IRS has charged 4%–8% interest annually.



CAUTION

IRS penalties are stackable. Late filing and paying penalties can be imposed by the IRS in addition to any other penalties, such as for fraud or filing an inaccurate return. Congress and the IRS believe the more the merrier when it comes to penalizing delinquent or erring taxpayers.

Underpaying Estimated Taxes

Self-employed people occasionally get dinged for the estimated tax penalty. All self-employed individuals who will have a balance of at least \$1,000 due on filing their tax returns must estimate their income tax for the year ahead and pay it in quarterly installments.

Quarterly estimated tax payments are due on April 15, June 15, September 15, and January 15 of each year. Quarterly payments should be equal—generally, you can't play catch-up with larger payments later in the year to avoid this penalty.

You must come pretty close to paying everything you will owe, although you don't have to guess the total amount precisely.

Here are the rules for avoiding the penalty:

- If you earn less than \$150,000, your quarterly tax payments must equal at least 90% of your final income tax bill, or at least 100% of your last year's tax bill.

- If you earn more than \$150,000, you must pay at least 110% of your last year's tax bill in estimated payments or risk the underpayment penalty on whatever amount you come up short. Under certain conditions, the IRS will waive the penalty. (See Publication 505 for more information.)

Interest on Tax Bills

Congress requires the IRS to charge interest on delinquent tax bills and has given the IRS very limited discretion in canceling interest charges.

The interest rate is adjusted every quarter by a formula and compounded typically ranging from 4%–8% per year. It is charged on a monthly basis and not prorated daily. Check the IRS website for the latest rate.

If you are audited and end up owing more tax, interest is charged starting on the original date the tax return was due usually April 15th of the audited year.

Understanding Penalty and Interest Notices

If you receive a tax bill with penalty and interest charges, it may not show how these charges were computed. For an explanation, call the IRS taxpayer assistance line (800-829-1040) and/or request that a penalty and interest explanation notice (PINEX) be sent to you.

A PINEX is a multipage computer printout that includes:

- a listing of your business (or personal) tax accounts for the specific years or tax periods you request, showing all tax penalty and interest computations
- dates, interest rates, penalties assessed, and any credits to your account, such as your quarterly payments, abatements (reductions) by the IRS, or any refunds applied

- explanations of why particular penalties were charged, with tax code citations authorizing each penalty, and
- a summary of your account with balance due, including up-to-date penalty and interest amounts.

If you still have questions or disagree with the PINEX, call back the taxpayer assistance line and tell them why you believe it is incorrect.

How to Get Penalties Reduced or Eliminated

Once you understand why and how the IRS hit you with penalties, you may request that they be reduced or eliminated. The IRS term for this process is abatement. About one-third of all penalties are eventually abated. I suspect that even more penalties would be canceled if people knew how to contest them.

Just telling the IRS that you don't like a penalty, or can't afford to pay it, won't work. You must show reasonable cause, meaning a good excuse. The IRS instruction book for its agents, called *The Internal Revenue Manual (IRM)*, says, "Any sound reason advanced by a taxpayer as the cause for delay in filing a return, making deposits ... or paying tax when due will be carefully analyzed."

The IRM lists seven categories of excuses for abating any tax penalty except fraud:

1. Death or serious illness of the taxpayer or immediate family.
2. Unavoidable absence.
3. Destruction by fire or other casualty of the business or records.
4. Inability to determine the tax because of reasons beyond the taxpayer's control.
5. Civil disturbances.
6. Lack of funds, but only when the taxpayer can demonstrate the exercise of ordinary business care and prudence.

7. Other reasons establishing that the taxpayer exercised ordinary business care but couldn't comply within the time limits.

When requesting an abatement, try to fit your excuse into categories 1 to 6 first. If you honestly can't, try the catch-all number 7. This category covers just about any excuse you can come up with.

How to Request a Penalty Abatement

As soon as you receive a tax notice with penalties, request an abatement in writing, following the form letter below. Be brief and straightforward. State that you are requesting an abatement of penalties, identify the tax bill, and tell the IRS what your reasonable cause is.

Attach a photocopy of the IRS notice showing the penalty, along with any documentation supporting your request. Keep several copies of your letters and attachments.

Most penalties are imposed by the IRS Service Center that sent the tax bill, so mail your abatement request there—not to the local IRS office. The IRS is notorious for ignoring, losing, or taking forever to answer correspondence, so you may need to send additional copies later. Wait at least 45 days before sending your follow-up request. Photocopies of your first request and documents should be sufficient—just change the date of the request.



TIP

Stress your clean IRS record. If true, emphasize that you have never before had a penalty, been behind in paying taxes, or asked for an abatement. Even if your record is not squeaky clean, the IRS penalty examiner may let it go, so let your conscience be your guide.

Sample Letter Requesting Abatement of Penalties

To: Penalty Abatement Coordinator
IRS Service Center
P.O. Box 9941
Ogden, UT 84409

Re: Request for Penalty Abatement

From: Sanford Majors
43 Valley Road
Salt Lake City, UT 84000

SSN: 555-55-5555

November 3, 20xx

To Whom It May Concern:

I am requesting an abatement of penalties asserted in the IRS notice dated 5/5/20xx of \$2,312.10 (enclosed).

The reason I *[select one or more: filed late, paid late, didn't report some income]* was that *[fill in your reason, such as]*:

- I was suffering from a nervous breakdown.
- My wife had just passed away.
- My house burned down on April 14 with all of my tax records.
- *[any other excuse]*.

Enclosed is a *[describe your documents, such as]*:

- Letter from Dr. Freud explaining my condition, which prevented me from filing my tax return on time
- Death certificate confirming my wife's passing
- Report from the fire department
- *[any other documentation]*.

I have also enclosed payment that covers the amount of the underlying taxes I owe *[optional, but a good idea if you can afford to make the payment]*.

Please abate these penalties for reasonable cause. I can be reached at 801-555-3444 during daytime hours.

Thank you,

Sanford Majors

Sanford Majors

Enclosed: IRS Tax Notice; *[doctor's letter, death certificate, fire report, letter from State Department, or whatever]*

If Your Abatement Request Is Rejected

If the IRS Service Center officially rejects your request, it will send you a written notice. To go further, take one or more of these actions:

- Write back asking for IRS appeals consideration. There is no IRS form for this—just write a clear letter headed “Penalty Appeal” and explain your reasonable cause. Attach the tax bill in question and any documentation supporting your case, like a doctor’s letter or accident report.
- Call or visit your local IRS office and speak with a customer service representative or a collection employee. They are authorized to consider reasonable cause applications and cancel penalties. Don’t mention that a Service Center turned you down. If you’re turned down again, ask orally and follow up in writing requesting that they forward your case for appeals consideration.
- File an Offer in Compromise (IRS Form 656) based on doubt as to your liability for the penalty. This is a formal procedure for negotiating any unpaid IRS bill, including penalties. Don’t offer any money when contesting a penalty, because you are claiming that you don’t owe it. Follow the directions accompanying Form 656 precisely. Attach your explanation and documents supporting your position, if any. (Offers in Compromise are discussed in Chapter 19, *When You Can’t Pay Your Taxes*.)
- Pay the penalty and then file IRS Form 843, *Claim for Refund and Request of Abatement*. Attach a letter and substantiating documents (as you did to your abatement request letter), or write your explanation in the space provided on the form. If your claim is refused, theoretically you can sue in U.S. District Court or the Court of Federal Claims for a refund. Seldom are tax

penalties large enough to justify the expense of a lawsuit, however.

How to Get Interest Charges Removed

It is never easy to get interest removed from a tax bill, unless it resulted from an IRS error. In four instances, however, you might win:

- Logically enough, if a tax or penalty is abated, interest on that amount should be canceled, too. The IRS computer should do this automatically, but always check a tax bill to verify that the excess interest was removed. If you suspect a mistake, call the IRS at the number on the notice or at 800-829-1040. Ask them to explain on the phone or send you a PINEX. If you continue to get incorrect bills, write and call the IRS office that sent the bill.
- Did the interest charges result from delays by the IRS? For instance, say you settled an audit agreeing to pay more tax, and the IRS didn’t send a bill until a year later. The year’s interest should be canceled. However, you can’t get interest abated if it accumulated while you were (unsuccessfully) challenging an IRS bill through an audit appeal or in court.
- If the IRS concludes that you will never be able to pay the tax and interest charges, it may accept less in an Offer in Compromise. (See Chapter 19.)
- Interest, along with the tax and penalties, may be reduced or eliminated through bankruptcy. (See Chapter 19.)

Designating Payments on Delinquent Tax Bills

When paying tax bills that include both penalties and interest, tell the IRS how to apply

the payments. It might make a difference. For instance, if the bill is for a business-related tax, tell the IRS in writing that the payment is to be first applied to interest. Your request may not be granted, but if it is, the business-related interest is a deductible business expense. (Tax penalties, however, are never deductible.)

One exception to paying the interest first is for past due payroll or employment taxes. With payroll taxes for your incorporated business, payments should be designated to be first applied to the trust fund portion of the delinquent payroll tax. (See “Reporting and Depositing Payroll Taxes” in Chapter 6 for the reason why.)



TIP

Tell the IRS how to apply payments.

Always direct the IRS to apply payments to specific tax periods, if there is more than one for which you are delinquent. You want payments first applied to the most recent—not the oldest—tax period, because:

- The heaviest penalties are charged in the first few months after a tax return is due.
- The older a tax bill gets, the more likely the IRS is to compromise it, lose it in the shuffle, or let the ten-year statute of limitations on collection run out.
- Tax debts may qualify for discharge in bankruptcy.

If you don't tell the IRS which tax period to apply the payment to, it will automatically apply it to the oldest tax period.

To designate payments, write the tax period on the face of the payment check, along with your taxpayer identification number (your Social Security number or the Employer Identification Number of your business). Also, send a letter with

the check stating specifically what the payment is for. For instance, state “Apply to interest first for 2010 income taxes for TIN 555-55-5555.”

Penalties and Interest in a Nutshell

- Whenever you are late in filing a tax return or paying a bill, the IRS adds on penalties and interest.
- Penalties are discretionary with the IRS and may be canceled (abated) for showing of a “reasonable cause” excuse.
- The IRS must give you a full explanation of any penalty or interest charge.
- Interest charges are mandated by Congress and so are rarely excused by the IRS.

Resources

- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book discusses penalties, interest, and how to deal with them in greater detail than we go into in this chapter.
- IRS Notice 746, *Information About Your Notice, Penalty and Interest*. This notice is usually sent with your first tax bill that contains a penalty or interest charge. Download it from the IRS's website at www.irs.gov, call 800-829-1040, or go to your local IRS office.
- Bobby Covic (EA), one of the most knowledgeable tax pros I know in this area of practice, is available for telephone consultations on tax collection matters. He can be reached at 775-831-7694 or P.O. Box 6206, Incline Village, NV 89450.

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“The avoidance of taxes is the only intellectual pursuit that still carries any reward.”

— John Maynard Keynes

Our tax code is a moving target; tax laws are always being reworked by Congress. Keeping up with changes affecting you, your business, or your industry can be a challenge.

Small business owners can't afford to call a tax pro with every question. Fortunately, good tax information is available for free (or close to it). The IRS offers free publications on basic tax law—always from the IRS's point of view, of course. Trade associations put out newsletters and magazines covering tax concerns common to their members. General tax newsletters, books, and annual tax preparation publications are plentiful, and small business tax material is widely available in libraries. Of course, the Internet is a prime source of tax material.

You should have a good tax adviser on call. Keep professional fees under control by learning as much as you can on your own. The more you know, the better you can judge a tax pro's capabilities. And, of course, the less tax advice you'll have to pay for. I've tried to alert you to the occasions where you'll need professional help beyond this book by using “caution” and “see an expert” symbols.

For instance, a tax pro can help set up your record-keeping system and choose an accounting method. Or use a pro if you don't feel comfortable doing your own tax return. (Who does?) Everyone's business and individual tax situation is unique; like your wardrobe, some custom fitting always works better than off-the-rack. Here are some places to do your shopping.

Finding Answers to Tax Questions

The income tax law is a product of all three branches of our federal government:

- The legislative branch, Congress, writes the Internal Revenue Code (IRC), or tax code, for short. Each part, called a section, has its own number, like IRC § 179.
- The executive branch, specifically the Treasury Department, of which the Internal Revenue Service is a part, publishes interpretations of many tax code provisions. These writings show how the IRS applies the tax code in different situations.
- The judicial branch—the federal courts—interprets the tax code in light of the Constitution and what it divines as Congress's intent. When the IRS applies the tax code contrary to the Constitution or differently than Congress intended, it may be overruled by the federal courts. These court decisions are published (“reported”) and serve to guide taxpayers on how to interpret the tax code.

IRS Small Business Website

There is an IRS small business community website to assist the nation's 45 million business and self-employed taxpayers. This free site provides:

- answers to basic tax questions and a calendar of tax deadlines
- online access to most IRS forms
- industry-specific tax info for specific industries like construction and food service
- tips to avoid common tax problems
- links to court opinions and to rulings and regulations on specific industries
- links to non-IRS sites for general tax information, and
- links to helpful small business resources.

Go to the IRS home page (www.irs.gov). Click on “Business” and then “Small Business and Self-Employed.” You can also sign up for a free IRS electronic publication, *E-news for Small Business*, [here](#).

This section discusses where to find the pronouncements of the government, IRS publications, private tax guides, textbooks, websites, court decisions, and periodicals. Some are free, and most others are reasonably priced. Tax publications for professionals are expensive, but are often available at public or law libraries.

IRS Booklets and CD-ROM

The IRS publishes over 350 free booklets explaining the tax code. But where there is a gray area in the law, you can bet you'll get only the IRS's interpretation—even if federal courts have made contrary rulings.

These IRS Publications ("Pubs," for short), range from several pages to several hundred pages in length. Get them at IRS offices, download them online at www.irs.gov, call 800-829-FORM (3676), or send in an order form. There is no charge, not even for postage. (A list of free IRS tax publications for small businesses is in the appendix.)

Here are some key IRS publications for small business owners:

- Publication 334, *Tax Guide for Small Business*
- Publication 583, *Taxpayers Starting a Business*
- Publication 910, *Guide to Free Tax Services*
- Publication 1057, *Small Business Tax Education Program Brochure*
- Publication 1544, *Reporting Cash Payments of Over \$10,000*, and
- Publication 1779, *Employee or Independent Contractor*.

You can get all IRS publications, plus 600 forms, IRS Regulations, and back-year tax forms (to 1991) on CD-ROM Publication 1796. Call toll-free 877-233-6767, or order online at www.irs.gov (search for Publication 1796). The cost is \$30 if ordered online, or \$36 if ordered by mail or phone.

All you may need, however, is a free CD-ROM called the *Virtual Small Business Tax Workshop*, Publication 1066-C. You can order it by telephone at 800-829-3676. It contains:

- information on small business topics from various regulatory agencies
- business tax forms, instructions, and publications
- valuable insight on a wide range of topics, from preparing a business plan to keeping records of financing and retirement plans
- informative tutorials, updates, and a multi-agency electronic newsletter.



TIP

Don't rely exclusively on the IRS for information. The IRS's free publications run the gamut from good to bad to plain ugly. While some are clearly written and useful, others are misleading, and a few are in an unknown language. I am always amused to see IRS publications with disclaimers warning you against relying on them. The IRS is not legally bound to follow its own writings that explain the tax law. Amazing, isn't it?

Free IRS and Social Security Telephone Information

The IRS offers prerecorded tapes on tax topics on its toll-free telephone service (TELETAX) at 800-829-4477. See IRS Publication 910 for a list of topics.

You may talk to a live IRS taxpayer service representative at 800-829-4933 (business tax line). It can be hard to get through from January to May. Avoid calling on Mondays or during lunchtime.

The Social Security Administration (SSA) also has an 800 number: 800-772-1213. It is staffed 7 a.m. to 7 p.m., and has prerecorded business-related topics available 24 hours a day. Among other info available from the SSA, you or an employee of your business can get a statement

of earnings, Form W-2, and Form 1099 income information for past years, an estimate of Social Security benefits, and new or replacement Social Security cards.



RELATED TOPIC

For information on how to contact the IRS, see “Quick and Easy Access to IRS Tax Help and Tax Products” in the Appendix.



CAUTION

Be alert for bad IRS advice. The IRS is notorious for giving misleading or outright wrong answers on the phone. IRS workers just aren’t trained to answer more than very simple tax questions. In the IRS’s defense, often taxpayers don’t know how to ask the right questions, or really understand the answers given. Our overly complex tax code is as much to blame as the IRS. Unfortunately, the IRS does not stand behind incorrect oral advice. If you rely on what someone at the IRS tells you and it is wrong, you’ll be liable for any resulting tax plus interest and penalties. If it’s important, double check what the IRS tells you with a tax pro.

Free IRS Programs

In larger metropolitan areas, the IRS offers small business seminars on various topics, such as payroll tax reporting. You can ask questions at these programs, given at schools and federal buildings. Call the IRS at 800-829-1040 to see if programs are offered near you and to get on the IRS small business mailing list.

If you are age 60 or older or qualify as low income, with or without a small business, you may be eligible for free tax assistance under the VITA (Volunteer Income Tax Assistance) or TCE (Tax Counseling for the Elderly) programs. For details, call the IRS at 800-829-1040.

IRS Written Advice

Strange as it may seem, the IRS is only legally bound by advice given through the Private Letter Rulings (PTL) process. To get a PTL you must submit a formal request, following IRS guidelines, and then wait months for an answer. The IRS is not required to issue a PTL if it doesn’t want to. One last thing you should know—there is a fee, ranging from \$625 to \$11,500 for getting a PTL. Still interested? I didn’t think so.

For issues where the law isn’t clear, a better (and far cheaper) bet is to look up letter rulings issued to other taxpayers with a similar question—if you can find one. Letter rulings are published in the *Internal Revenue Cumulative Bulletin*, and in private tax service publications found in larger public and law libraries.

Be warned: It is not easy to find letter rulings on point, even for a tax pro. If you want to try, you should know how these rulings are identified and indexed. For example, “Ltr. Rul. 892012” refers to a ruling issued in 1989, in the 20th week, and which was the 12th letter ruling issued that week. My suggestion is that you hire a tax pro to do this for you.

Internal Revenue Code

The Internal Revenue Code (IRC) is written by Congress and is nicknamed the code or the tax code. It’s a thick book with tiny print and is found in the reference section of most libraries, the IRS website, IRS offices, tax pros’ offices, and larger bookstores. The IRC is revised annually—mostly minor changes by Congress. More significant revisions to the tax code are made every three to four years.

The IRC is found in Title 26 of the United States Code (U.S.C. for short). The U.S.C. encompasses all of our federal laws. Title simply refers to the place within the massive U.S.C. where the IRC is found.

EXAMPLE: “IRC § 179(b)(4)(A)” means that this particular tax law is found in Title 26 of the U.S.C., the Internal Revenue Code, Section 179, subsection b, paragraph 4, subparagraph A.

The IRC is divided up into sections, which, in turn, are subdivided into more parts, ad infinitum. The tax code is a crazy quilt of laws that apply to everyone along with provisions just for left-handed sheep breeders in New Jersey.

The IRC is available at larger bookstores and online at www.irs.gov. The U.S. Code (including the IRC) is also available on CD-ROM from the Government Printing Office for \$45.

IRS Interpretations of the Tax Code

Congress, when enacting a broadly applicable tax law, can't foresee all possible situations. So the Treasury Department (the IRS is a part of it) is authorized to issue interpretations of broad tax code provisions. The primary IRS interpretations are called Regulations, Revenue Rulings, Letter Rulings, Revenue Procedures, Announcements, Notices, the Internal Revenue Manual, and IRS forms and instructions.

Regulations

The most authoritative IRS interpretations are called Treasury Regulations or just Regulations or Regs. Regulations provide the mechanics of how many (but not all) tax code provisions apply. Regulations often include examples, like the ones in this book. They are usually bound in a four-to six-volume set and are found in most larger libraries and some bookstores. Regulations are on the IRS website (www.irs.gov). Regulations are easier to read than the tax code on which they are based.

Start with the IRC section number. Then check to see if there is a corresponding regulation. It will

bear the same number, usually preceded by the numeral “1.” You can do this online at www.irs.gov.

EXAMPLE: “Reg. 1.179” refers to a Treasury regulation interpreting IRC Section 179.

Other IRS pronouncements

The IRS publishes various statements of its position on various tax matters. These pronouncements guide IRS personnel and taxpayers as to how specific tax laws will be applied by the IRS.

IRS Revenue Rulings (Rev. Rul.) are IRS announcements of how the tax law applies to a hypothetical set of facts.

Tax book publishers Prentice-Hall, Commerce Clearing House, and Research Institute of America reprint all IRS Revenue Rulings. Some, but not all, of the IRS Revenue Rulings are on the IRS website. They are indexed by IRC section and subject matter. A Revenue Ruling usually contains a factual example, followed by an explanation of how the tax code applies to those facts. While looking for a Revenue Ruling might pay off, it is not always easy to find one that precisely covers your situation.

EXAMPLE: “Rev. Rul. 92-41” refers to IRS Revenue Ruling number 41, issued in 1992.

IRS Letter Rulings are IRS answers to specific written questions about more complex tax situations posed by taxpayers. See “IRS Written Advice,” above.

IRS Revenue Procedures (Rev. Procs.) are another way the IRS tells taxpayers exactly how to comply with certain tax code provisions. Rev. Procs. are primarily relied on by tax return preparers. They often explain when and how to report tax items, such as claiming a net operating loss on a tax return. They are contained in the weekly *Internal Revenue Cumulative Bulletin*, found in larger public and law libraries. They also are reprinted by

the tax book publishers mentioned above and are on the IRS website (www.irs.gov).

EXAMPLE: “Rev. Proc. 91-15” refers to a published Revenue Procedure number 15, issued in 1991.

IRS announcements and notices. Periodically, the IRS gives general guidance and statements of policy in official announcements and notices similar to press releases. They appear in the weekly *Internal Revenue Cumulative Bulletin*, which is published at www.irs.gov. Seldom does it pay to search IRS announcements or notices, as they weren’t intended to answer specific questions.

The Internal Revenue Manual (IRM) is a collection of IRS handbooks, called “parts.” Although written for IRS personnel, most of the IRM is available online at www.irs.gov. The IRM tells auditors, criminal investigators, appeals officers, and collectors how to interpret, apply, and enforce the tax laws. For example, one part deals with the criteria the IRS uses to decide whether reasonable cause exists for canceling a penalty. This can be very useful information for taxpayers too.

IRS forms and instructions are well known to us all, starting with Form 1040, the annual personal income tax return. More than 650 other forms are listed in Publication 676, *Catalog of Federal Tax Forms*. They are free at IRS offices, by calling 800-829-FORM or 800-829-1040, or at the IRS website at www.irs.gov. Many IRS forms come with instructions and explanations of the tax law. Always read the instructions before attempting to fill in an IRS form.

Court Cases

Federal courts have interpreted the tax law in thousands of court cases. Tax court decisions are found in the *Tax Court Reports*. The U.S. District Courts, U.S. Courts of Appeal, Court of Federal Claims, U.S. Bankruptcy Courts, and the

Supreme Court all rule on tax issues. These court decisions explain tax code sections. Chances are that at least one of these courts has adjudged the point you are interested in; the trick is finding it.

Researching court decisions goes beyond this book, but I can make a few suggestions. Go to Nolo’s website at www.nolo.com. Or, find your nearest law library with public access. Call a federal court, college library, or lawyer’s office to find out where to go. Instead of volumes that simply reprint court decisions, look for books by private tax services that summarize the cases and put them into a coherent order.



TIP

Advice on research. The key to tax research, whether on the Internet or in a law library, is to start with the number of an IRC section, a court case name, or a general topic, such as depreciation. If you are in a law library, head for the tax section or, better, ask the law library staff for help. A friendly librarian (someone who knows the way around the tax section) can show you how to use the books and its computer research services. Also look at the legal research books listed at the end of this chapter, which are available from their publishers or at bookstores.

Federal Small Business Programs

The Small Business Administration (SBA) guarantees business loans and also puts out some good publications.

Personal counseling from the SBA is offered by the Service Corps of Retired Executives (SCORE) program. These people are not necessarily tax experts, but if they were in business, they know the tax game. Call the SBA at 800-827-5722 or visit the SBA office nearest you. The SBA also has a very helpful website at www.sba.gov. Or write to the SBA at 1441 L Street, NW, Washington, DC 20461.

Small Business Development Centers (SBDCs) are cosponsored by the SBA and state governments. They are usually affiliated with state universities and provide free or low-cost seminars and counseling to small business owners. To locate an SBDC near you, call the SBA at 800-827-5722.

Other federal agencies offer publications—either free or at reasonable prices—to assist small businesses. For a list of federal publications, write to:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250-7954.

Private Tax Guides and Software

There is a multitude of commercially published tax guides and newsletters. Annual tax preparation guidebooks, like *Ernst & Young's Tax Guide*, are available at a reasonable price. Most are directed at taxes for individuals, but many deal with self-employment tax issues as well. Some of my favorites are listed at the end of this chapter.

Tax professional desk books are one-volume guides with more detailed tax information for corporations, partnerships, and LLCs. They presume some basic tax knowledge on the reader's part and are priced at \$50 and up. See the “Resources” list at the end of the chapter.

Tax preparation computer programs usually include basic tax guidance. I recommend *TurboTax* (Intuit)—other programs may be cheaper but they don't match up to *TurboTax* for small business owners. There are several versions of this software. *TurboTax Home & Business* is fine for solos and single-member LLCs, and *TurboTax for Business* is good for all other business entities—partnerships, multimember LLCs, and corporations.

Trade Association Publications

Every business or trade has specialized publications and newsletters that track tax issues in your industry that your tax pro might not know of—perhaps a new case or IRS ruling. Also, speakers on tax topics are often found at conventions and trade shows.

Tax Info Online

There has been an explosion of tax information on the Internet. Surprisingly, the IRS itself has a good website, but it is definitely not the “last word” in tax research.

Start your Internet search with the IRS home page at www.irs.gov. You can download over 600 IRS forms and publications and peruse summaries of 150 tax topics. Email simple tax questions to the IRS (but remember what I have said about taking tax advice from the IRS with a block of salt).

You can also do general searches on the Internet. Some sites allow you to post tax questions to experts and receive answers, either for free or a relatively small charge.

Keep in mind the person giving the answer doesn't really know you and your tax needs. The right tax answer is usually the one tailored to your individual situation—and for that you need the personal touch of meeting with a tax pro.

Here are some other helpful tax sites:

- www.taxesites.com has a comprehensive list of links to tax topics.
- www.unclefed.com includes all IRS forms (downloadable) as well as tax articles from tax pros (including yours truly).
- www.sisterstates.com has state tax forms and info.
- www.turbotax.com is a good all-purpose website.

To go still deeper into cyberspace, use one of the popular search engines such as Google or Yahoo! Be prepared for thousands of listings

to pop up. There is a lot of tax nonsense on the Internet. People can express their views or promote harebrained “untax yourself” schemes. So, watch out. In the tax universe, as elsewhere, if it sounds too good to be true ... you know the rest.

Finding and Using a Tax Pro

Mastering the tax rules is a Herculean task, given everything else a businessperson has to do. Armed with the basics (from reading this book and other resources), it makes sense to get to know a tax professional. Form a long-term relationship, calling any time a tax issue arises. Just what are tax pros, and how can you find one? Read on.

Types of Tax Advisers and Preparers

Tax advisers are of many varieties, and not all are created equal. Just about anyone can claim to be a tax expert.

Look for someone specifically knowledgeable in helping small businesses—not the storefront outfit that advertises rapid refunds, or an expensive national CPA firm. Ideally, pick a professional who already understands your particular type of business—whether you are a manufacturer, a consultant, a restaurateur, or a retail seller. Look for one of the following types of tax pros:

Tax return preparer. People who prepare tax returns can, but don’t have to be, licensed by the IRS. Make sure your tax preparer has one of these three professional designations:

- **Enrolled Agent (EA).** An EA is a tax adviser and preparer who is licensed by the IRS. This professional designation is earned by either passing a difficult IRS test or having at least five years of experience working for the IRS. There are 24,000 EAs in the United States. Enrolled Agents are the least expensive of the true tax pros. Many EAs offer bookkeeping and accounting assistance.

- **Tax attorney.** A tax attorney is a lawyer with either a special tax law degree (LL.M. in taxation) or a tax specialization certification from a state bar association. If you have a serious tax or IRS problem, require legal representation in court, or need business and estate planning, go to a tax attorney.
- **Certified Public Accountant (CPA) and other accountants.** CPAs are licensed and regulated by each state, like attorneys. They perform sophisticated accounting and business-related tax work and prepare tax returns. CPAs should be considered by partnerships, LLCs, or corporations or for complex business tax returns. CPAs are found in large national firms or in small local outfits. (Some states also license Public Accountants, who are not as highly regarded as CPAs.)

For typical small business tax needs I lean toward local EAs and CPA firms. National CPA firms and tax attorneys are more costly. Interview several tax pros to get a feel for the right one for your business.

How Tax Pros Can Help

A tax pro can assist you with the following:

Information and advice. A good tax pro can be a very effective teacher. (If your present adviser told you about this book or gave it to you, hurrah! You are working with someone who respects your ability to help yourself.) She or he can help make key tax decisions, such as choosing the best entity for your business and preparing financial statements necessary for obtaining loans.

Record keeping. Some people would do about anything to avoid record keeping. That’s why God created bean counters and small business software that makes record keeping (almost) fun. See Chapter 4 for what record keeping entails before deciding what’s best. Or see a pro for setting up a system tailored for your business.

Tax form preparation. Once you get past the record keeping, you'll face various tax filings. Congress talks about tax simplification, but don't hold your breath. Until that day, seriously consider professional assistance for your business tax forms. If you insist on doing it yourself, run it by a tax pro before filing it. For do-it-yourselfers, I recommend Intuit's *TurboTax Premium* or *TurboTax for Business*. However, a tax pro can point out tax deductions or other benefits that you and your computer might miss, as well as make sure you do it correctly.

Advice on dealing with the IRS. For help in dealing with the IRS, a tax pro can be an on-call coach. Some thorny questions may be answered in a minute or two by a canny tax pro.

Representation. You don't have to deal with the IRS at all if you hire an attorney, CPA, or Enrolled Agent to represent you. These folks know how to handle IRS bureaucracy. A tax pro can neutralize the intimidation factor the IRS knows it holds over you. And if you have something you would rather not have the IRS see, a pro might be able to keep the lid on it.

Choosing the Right Tax Pro for Your Business

There are several ways to find a good tax pro; asking the IRS is not one of them. Instead, try the following:

- **Personal referrals.** Ask friends, family, your attorney or banker, business associates, or even competitors for the names of tax pros they know or have dealt with.
- **Advertising.** Trade journals, directories, phone books, and newspapers carry lists of tax pros. Look under "accountants," "tax return preparers," and "attorneys—tax." Some offer free initial consultations. If they are advertising, they have time for new clients, but they also may be new to the tax game.

- **Professional associations and referral panels.**

Check the phone book for local bar associations and CPA societies that can refer you to a tax attorney or accountant. A referral shouldn't be construed as a recommendation or certification of competence. Find a CPA online at www.cpadirectory.com. The National Association of Enrolled Agents (800-424-4339 or www.nea.org) can help you locate an EA.

Interview at least three pros to see how well you relate to each other. Break the ice by telling who referred you. Then discuss your situation, and ask if it's okay to contact the pro's other clients who may be in a similar business. Ask if the pro is too busy to take on new work. If so, ask the pro for the recommendation of someone else.

If you worked with a tax preparer before you went into business, maybe this is the person you want to stick with, but maybe not. Ask about the person's experience with small businesses like yours.

Ask questions. Test a tax pro's attitude toward the IRS and knowledge of small business taxes by pulling questions from this book. Someone with prior IRS work experience is not necessarily desirable—they may have been permanently imprinted with the IRS point of view.

Ask how long the pro has been in practice and if he or she has represented clients before the IRS, and specifically in IRS audits. If not, the person is probably not as experienced as you would like.

Ask if the pro is doing your tax work or handing it off to a junior person or, worse, outsourcing it. Many U.S. tax returns are being sent by tax firms to India without telling the taxpayer.

Beware of tax pros who try to sell you investment products or insurance. Unfortunately, there is a trend for some tax pros to use tax preparation as a way to pitch high commission financial products.

Also ask yourself some questions as you go through the selection process: Does the tax pro give you a feeling of confidence? Is he or she knowledgeable? How long has the person been doing tax work? Can you envision him or her going to bat for you in front of the IRS? Finally, ask yourself, “Is this someone I would feel comfortable working with?”



CAUTION

Don't be in a hurry to hire a tax pro.

Looking for the right tax pro should be more like looking for a mate for life than a casual date. After all, complying with the tax laws is a key to whether your business lives or dies. The best time to look is in the summer or fall—not the January to May tax season. Once you find a good pro, stick with that person unless there's a good reason to switch.

Tax Pros Aren't Cheap

There's no standard price for tax work. Good tax pros aren't cheap. A start-up business without much cash flow should shop around. But keep in mind that an expensive expert who saves you from getting in trouble is a bargain in the long run.

Get a clear understanding of costs up front. Does the pro charge by the hour or have flat (fixed) fees for bookkeeping, accounting, and tax form preparation? Professionals working on an hourly basis charge from a low of \$50 per hour up to \$500 for top CPAs and tax attorneys.

Get a written fee agreement up front so you have a basis for disputing a tax pro bill later on, if necessary.

Tax pros can either be consulted as needed or hired to take over tasks from bookkeeping to IRS filings and representation.



TIP

Fees may be negotiable. Do you like the tax pro, but not the fee? Ask if the work can be done for less. Try something like, “I am new in business and need to watch my pennies.” If the person believes you'll be a long-term client, or if you show up in a slow period, you might get a discount on rates. The best time to hire a tax pro is after the tax season—meaning the summer or fall.

Tax Help in a Nutshell

- The IRS has many free publications which explain the tax law, but these are always from the government's point of view. (See Appendix.)
- Tax help from the IRS is not official and binding unless it is in writing.
- Many free or low-cost tax resources are available on the Internet (for example, www.taxattorneydaily.com).
- Small business owners should have a tax pro on call.

Resources

At the end of each chapter is a list of resources specific to that topic. Start there first, and then go to the more general list here.

- *Internal Revenue Code (IRC)*. This book has more fine print than you ever thought you would find in one place, but it is the tax bible and is available on the IRS website at www.irs.gov.
- *Regulations (Federal Income Tax Regulations)*. Only slightly more comprehensible than the IRC, Regulations are written by the Treasury Department to elaborate on the tax code. Find Regulations online at www.irs.gov.
- *The Ernst & Young Tax Guide* (John Wiley & Sons). This is my favorite annual tax preparation guidebook. It includes tips and explanations of the tax law far superior to the IRS's publications.
- *Master Tax Guide* (Commerce Clearing House). This book is written for tax pros and may be more technical than you want.
- *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo). This is a good companion book to the one in your hand; it covers the nontax aspects of small business as well as any book I have ever seen.

- *Stand Up to the IRS*, by Frederick W. Daily (Nolo). This book contains more detailed information on dealing with the IRS.
- *The Employer's Legal Handbook*, by Fred Steingold (Nolo). This book covers all aspects of being an employer, including tax obligations, in greater detail than covered here.
- *TurboTax* (Intuit). This software will make your small business taxes less painful if you don't use a tax preparer.
- IRS business tax line, 800-829-4933. For general questions on business-related tax forms, such as Forms 940 and 941.
- *Small Business Taxes Made Easy*, by Eva Rosenberg (McGraw-Hill). This book supplements many of the topics in this book and adds a few new ones. The author has a website with tax information (www.taxmama.com).

Some recommended tax information websites:

- www.unclefed.com
- www.taxmama.com
- www.taxesites.com
- www.taxattorneydaily.com

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1. Do I have to file a federal income tax return for my business if I lost money?

Technically no, unless you are a corporation, but you should do it anyway. Your loss could provide you with a tax benefit by reducing your other taxable income in that year or in past or future years. To report this loss, either attach a written statement to the loss year's tax return, or attach IRS Form 3621, *Net Operating Loss Computation*. (If you weren't active in the business, but merely an investor, your ability to deduct a business loss is limited.)

If your business is incorporated, you *must* file an annual tax return whether or not you have any income. Plus, the loss rules for small corporate shareholders are more generous. (See "Incorporated Business Losses" in Chapter 5.)

2. What does the term "depreciation" mean?

Depreciation refers to the annual tax deduction the IRS allows for a business asset that has a useful life of more than a year. The theory is that an asset loses value as it wears out over time, and you get a tax break reflecting that. The amount you may deduct per year, and the length of time over which you must take these deductions, depends on how the tax code classifies the property. (See Chapter 3.)

3. How long do I have to keep my business records?

The bare minimum period for keeping those dust-catching boxes is three years from the date you file your tax return. This is the normal IRS statute of limitations on audits. However, some state tax agencies have longer periods to audit, and the IRS can go beyond three years for serious underreporting. For this reason, as much as it may pain you, hold on to those boxes for at least six years. (See Chapters 4 and 20.)

4. I'm a doctor and I had patients who didn't pay their medical bills. Can I deduct this as bad debt expense?

The prognosis is not favorable, Doctor. The tax code specifically excludes the value of services provided from the definition of tax deductible bad debt. However, any out-of-pocket expenses (medications, needles, or supplies) in connection with providing these services to deadbeat patients are deductible. (See Chapter 2.)

5. If I incorporate my one-man consulting operation, will I reduce my audit risks?

Probably. In the past, the IRS audit rate for incorporated small businesses with under \$1,000,000 gross receipts has been less than half of similar unincorporated ventures. The IRS vows that it will equalize audit rates in the future, but who knows? Investigate the initial costs and recurring expenses of incorporating before you rush out and add "Inc." to your name—operating a corporation is more complex than operating as a sole proprietor. (See Chapter 8.)

6. Do I need any kind of prior IRS approval or registration before I start my business?

Not if you are starting off as a sole proprietor without employees. Just use your own Social Security number when corresponding or filing anything with the IRS.

But if you form any kind of business entity (a corporation, a partnership, or an LLC) or have one or more employees, you must get a federal Employer Identification Number at the time you begin operations.

You can obtain a federal Employer Identification Number using IRS Form SS-4. You will use this number on any forms you file with the IRS. Also, check with your state employment and tax authorities for their requirements. (See Chapter 6.)

7. I make dollhouse furniture in my spare time and sell a few items to friends and at craft fairs. Overall, I lose money every year, but have a good time at it. Are my losses tax deductible?

Possibly. The best way to pass muster with the IRS is to show that you had a profit motive and operated in a businesslike fashion. If you are ever audited, the auditor may try to argue that the dollhouse business was really a nondeductible hobby, and disallow your losses. Keep good records to show your efforts to turn a profit, and do some advertising or business promotion, just like any real business. Keep in mind that you only have to show that you *tried* to make a profit—it doesn't matter whether you actually did (although an IRS auditor might try to tell you otherwise). (See Chapter 14.)

8. Do IRA, SEP, 401(k), and other retirement plans for the self-employed really provide much of a tax break?

Absolutely. There is no better tax benefit available to the small business owner than a retirement plan. With the exception of the Roth IRA, you'll get an immediate tax savings for every year you contribute, and the money you invest in your plan will accumulate interest, dividends, and capital gains—with the tax deferred until you withdraw it.

Also, although retirement may be many years away, you can often make early withdrawals for buying a home or for medical reasons. Don't wait—the sooner you start contributing to a plan, the sooner your money can start making money for you. (See Chapter 16.)

9. Should I choose a fiscal year or calendar tax year accounting period for my business?

For most small-time operators, the accounting period is rarely a big deal either way. The vast majority of small businesses use a calendar year (January 1 to December 31).

To choose any other tax period, you must have a good reason and get permission from the IRS. If, for instance, your business is seasonal, such as farming, and you think you might benefit from a noncalendar fiscal year, see an accountant to discuss the ramifications. (See Chapter 4.)

10. If I claim a home office deduction for my consulting business, will I be audited?

Several years ago, home offices were IRS targets. Today, while a home office deduction increases your chances of audit, it's only a slight increase—unless the deduction is particularly large (50% or more) relative to your business income. (See Chapter 20.)

11. I use my car to call on customers and make deliveries. Am I better off leasing a vehicle or buying it?

As a rule, the more expensive the car, the bigger tax deduction you get from leasing. The price point at which leasing becomes more favorable is about \$15,800. When you get up in \$50,000 territory, vehicle deductions are much greater than with owning. However, if you are thinking of a big truck or a heavy SUV, you might be better off buying, because the annual tax deductions for these vehicles are far bigger than for passenger cars. And, using Section 179, you might be able to write 100% off in the year of purchase! (See “Section 179: Expensing Business Assets” and “Depreciating Business Assets” in Chapter 3.)

12. There is a trade show in San Francisco coming up and I'd like to take my wife and spend a few extra days after the show. Can I still deduct the trip expenses?

Yes, but you can't deduct any expenses (such as airfare and food) solely attributable to your wife unless she is an employee of your business and

is there for business reasons, too. (Hint, hint.) However, you can deduct all of your airfare, the full cost of your shared hotel room (for the business days, but not the extra days), and the rental car for the business days. And, if you can find one of those “companion flies free” deals, you don’t have to account for your wife’s airfare at all. Make sure to take her for a drink at the Cliff House at sunset. (See “Travel and Lodging” in Chapter 15.)

13. Two friends and I want to go into business building and fixing stock cars for racing. What’s the simplest way to do this taxwise?

Consider forming a limited liability company (LLC). Your other alternatives are a partnership or a corporation, which may be more complicated tax-wise and legally than an LLC.

The best advice I can give you is to meet with a business lawyer and talk to a tax pro about your plans and get advice tailored to your situation. See you at Daytona. (See Chapter 11.)

14. Will the IRS be upset if I hire my 14-year-old kid to help in my video store after school, sweeping floors, answering the phone, and so on? I would pay him about \$50 a week.

Hiring Junior and Little Susie is perfectly okay (and it keeps the kids off the streets). In fact, it’s a good family tax saver, too. It takes income from your tax bracket and transfers it to the child’s lower bracket. Make the kids do real work, and don’t overpay them—their (tax deductible) salaries shouldn’t be just disguised weekly allowances.

As an added benefit, the kids can put money into retirement plans and deduct the contributions. This makes good tax sense even if they take the money out for college—long before retirement age. (See Chapter 13.)

15. My cousin Luigi and his wife own a multimillion-dollar floor covering business. His daughter and one son work in the business. Could operating the business as a family limited partnership save estate taxes on his death?

If Luigi plans far enough ahead, yes, putting the floor covering operation into a family limited partnership (FLP) can reduce the size of his taxable estate and cut probate time and costs.

Luigi could gradually transfer ownership of the business to his children over a period of years through annual tax-free gifts (right now, the maximum amount Luigi and his wife can contribute tax free is \$26,000 in partnership interests to each family member per year). (See Chapter 13.)

16. I frequently give my employees gift certificates and special occasion items to keep them loyal. What are the tax rules for deducting the costs of these things?

First, congratulations for your enlightened approach to holding on to valuable employees. You can deduct all of the costs of gifts to employees; the catch is that anything totaling more than \$25 per year must be reported as additional income by the employee.

There are ways to get around this paltry \$25 limit. A service business can provide “excess capacity” things (services that wouldn’t be used anyway, such as an open room in your bed and breakfast) to your employees tax free. And, owners can give “good habit” rewards of up to \$400 per year per employee, or with a qualified award plan, you can give items valued up to \$1,600 per year per employee. Check with your tax pro for more information. (Also see “Gifts, Rewards, Discounts, and Free Services for Employees” in Chapter 15.)

17. I'm buying a small injection molding company that has gross receipts of about \$500,000 per year. How do I tell the IRS about this deal?

If you are buying an unincorporated business, both you and the seller must agree on the value of each category of assets being transferred. This means things like equipment, real property, goodwill, the seller's covenant not to compete, and so on. Both sides report these allocations with their next tax return filings by including an IRS Form 8594, *Asset Acquisition Statement*.

However, if you buy shares of stock in a corporation, there is no special IRS reporting form to file. (See Chapter 17.)

18. My auto dealership went through some rough times last year. I got behind in payroll tax deposits for \$120,000 and I owe suppliers, the landlord, and others even more. Can these payroll taxes be wiped out in bankruptcy?

Sorry, no can do. Congress (in conjunction with the IRS, no doubt) says that payroll taxes can never be discharged in a bankruptcy. The best thing to do is use whatever assets you can to make the payroll tax payments and then file for bankruptcy. The suppliers' bills are most likely dischargeable in bankruptcy, so pay the IRS first.

The IRS is tenacious when it comes to collecting payroll taxes, and you could lose more than just your business. You may be able to make a deal with the IRS under an Offer in Compromise. (See "Dealing With a Monster Tax Bill" in Chapter 19.)

19. I am being audited by the IRS. The auditor says a number of my business expenses will be disallowed in his report. Do I have to accept this?

Absolutely not. The IRS has an administrative process that allows you to appeal an auditor's decision to the IRS Appeals Office—a completely

separate division of the IRS. Their job is to settle the dispute with you so you don't take the IRS to tax court. And, in most cases, they will compromise on an audit report—although your odds of being let off the hook completely are slim.

If you can't reach a compromise, the filing fee for tax court is only \$60, and if the amount you are contesting is less than \$50,000, the procedures are fairly simple. (See Chapter 21.)

20. I save a lot of taxes and benefit-related expenses by hiring independent contractors for my print shop instead of employees, but my accountant says I'm crazy to take the risk that they'll be reclassified as employees. What do you think?

Your accountant is right to be wary. Most small business owners love the tax savings they get from hiring independent contractors—they don't pay the employer's share of payroll taxes or unemployment taxes, or withhold income taxes as required by law. That's fine if the workers are legally independent contractors.

But if you are providing a workplace on your premises, setting the hours of work, and presumably directing the workers, then they probably aren't independent contractors, but employees—and you could be in big trouble with the IRS. The IRS is very aware of the tax benefits of hiring independent contractors and makes a habit of auditing businesses that hire a lot of independent contractors. Also, watch out for fines and penalties from your state tax agency as well if—or when—you are caught. (See Chapter 6.)

21. I'm thinking of opening a cosmetic store and I project about \$250,000 in sales the first year. Should I try to keep records by hand or with my computer?

Unless you are completely hopeless with a computer—and most people can pick up at least a few skills—forget the pencil and paper. Tracking

many relatively small sales, keeping inventory, sales tax reporting, and other such items is the stuff computers were made for. Most small business owners wouldn't dream of operating their business without a computer and a program like Intuit's *Quicken* or *QuickBooks*. (See Chapter 4.)

22. Our state has both a corporate and personal income tax. I've read that incorporating out of state (like in Delaware or Nevada) will save on costs and taxes—is this true?

No, just the opposite. You will still have to register and file corporate and personal tax returns in your home state, because that is where you are doing business. (That's the law in 50 of the 50 states.) Incorporating in a no- or low-tax state will result in higher overall costs and taxes, considering the expenses of forming and maintaining the out-of-state corporation. The legitimate reasons for incorporating out of state are all nontax—like favorable liability laws or greater privacy. If you're still tempted, talk to a business attorney and tax pro first. (See Chapters 8 and 9.)

23. I am a sole proprietor with a mailing and shipping store and a huge Social Security and Medicare tax bill. Is there any way to lower my tax bite?

Yes, by converting your business to an S corporation, and becoming an employee of the corporation. You can set your salary well below what you presently earn and take profits as dividends.

The catch: There are costs and legal fees for setting up and maintaining the corporation as well as tax pro fees for payroll and corporate tax return filings. For the average small business these costs might run \$2,000 per year—but they are all tax deductible. And, a side benefit is the personal liability shield that a corporation provides. But

before spending the money, get legal and tax advice from pros in your area. (See Chapter 9.)

24. I notice that you often recommend hiring tax professionals, but I can't afford that. Why can't I just read your book and call the IRS for free if I have any tax questions?

There are at least two reasons for not relying on this (or any other) book and the IRS as your sole sources of tax advice. First, everyone's overall tax circumstances are different. For instance, a \$1,000 tax deduction may save a high-earner like Patricia \$400 in federal and state income taxes but may not save a part-time student like Patrick a dime. It depends—on their tax rates, other deductions, dependents, and dozens of other highly individual considerations. This book or an IRS publication is only a one-size-fits-all overview.

Second, calling a live person at the IRS or relying on something in its publications or website is dangerous. Why? Believe it or not, the IRS is not legally liable for its oral advice or what is stated in its publications! Also, keep in mind that paying a private tax pro for advice is tax deductible, which should take out part of the sting of paying those fees. (See Chapter 23.)

25. My tax preparer typically says "no" whenever I ask if I can take a deduction that she thinks might bring down the IRS on me. Is she being too careful, or is she acting in my best interests?

Get someone else to do your taxes ... you are likely overpaying your income taxes by hundreds or even thousands of dollars every year. Of course the powers of the IRS should be respected, but you don't have to be a scared rabbit. For one thing, chances of an IRS audit nowadays are very low, and even if you are audited, it doesn't necessarily mean you will lose. Interview several tax pros. Ask them about taking deductions, and

about their attitude toward the IRS. When you find a good fit, make the switch. (See Chapter 23.)

26. I freelance as a writer from home but am a renter, not an owner. Can I still take a home office deduction?

You can. Check out how to do this in Chapter 14.

27. I missed taking a deduction last year. Can I go back and claim it now?

Yes. Most deductions—business or personal—can be taken by filing Form 1040X, *Amended U.S.*

Individual Tax Return, within three years of the date you filed the original return. You should get a refund, with interest, from the IRS. (See Chapter 20.)

28. I missed a tax return filing deadline and don't know what to do. Should I call the IRS?

No. Just file asap. The IRS may (or may not) assess a penalty for the late filing, and interest will be running on any taxes due. Better late than never though.



Glossary

The terms in this glossary are defined as they are used by the IRS or by the author. Some terms may have different meanings in other contexts.

Abatement. The IRS's partial or complete cancellation of taxes, penalties, or interest owed by a taxpayer.

Accelerated Depreciation. A method of tax deducting the cost of a business-used asset more rapidly than by using straight-line depreciation. *See* Depreciation.

Accountant. Someone who works with financial data. Often denotes a person with special training, such as a Certified Public Accountant.

Accounting. Process by which financial information about a business is recorded.

Accounting Methods. *See* Cash Method *and* Accrual Method.

Accounting Period. *See* Calendar Year Accounting Period *and* Fiscal Year Accounting Period.

Accounts Payable. Money owed by a business to suppliers, vendors, and other creditors; a business liability.

Accounts Receivable. Money owed to a business for goods or services rendered. A business asset.

Accrual Method of Accounting (also called Accrual Basis). Accounting for income in the 12-month period earned, and for expenses when the liability was incurred. This is not necessarily in the period when it is received or paid. *See also* Cash Method.

Adjusted Basis. *See* Basis (Tax Basis).

Adjusted Gross Income (AGI). On personal income tax returns, Form 1040, this figure is the result of reducing a taxpayer's total income by certain

adjustments allowed by the tax code, such as a contribution to a traditional IRA. From this figure, personal deductions are subtracted to arrive at taxable income. *See also* Taxable Income.

Adjustment. (1) An IRS change, usually by an auditor, to a tax liability as reported originally on a tax return. (2) Deductions from an individual taxpayer's total income on Form 1040, lines 23 through 30.

Alternative Minimum Tax (AMT). A federal flat tax on income of individuals or corporations that may apply when a taxpayer claims certain tax benefits that reduce tax liabilities below specified levels. The AMT prevents higher-income taxpayers from getting too many tax benefits from things like accelerated depreciation or investments in municipal bonds.

Amended Tax Return. Generally, amended tax returns may be filed by an individual or entity to correct an error made on a previously filed return or to get a refund of taxes paid.

Amortization. A tax method of recovering costs of certain assets by taking deductions evenly over time. This is similar to straight-line depreciation and unlike an accelerated depreciation method. For example, when someone buys a company, the Internal Revenue Code directs that business goodwill costs must be amortized over 15 years by the buyer.

Appeal. (1) Administrative process allowing taxpayers to contest certain decisions, typically audits, within the IRS. (2) Judicial process for reviewing decisions of lower courts.

Assess. The IRS process of recording a tax liability in the account of a taxpayer.

Asset (Business). Any property with a value and useful life of at least one year that is used in a trade or business. Examples: machinery, buildings, vehicles, equipment, patents, and monies held or owed to a business. *See also* Accounts Receivable.

Audit. A review of financial records. An IRS audit is the examination of a taxpayer, his or her tax return, and supporting data to determine whether he or she has violated the tax laws.

Auditor. An IRS Examination Division employee who reviews the correctness of a tax return. *See also* Revenue Agent; Tax Auditor (Examiner).

Bad Debt (Business). Money owed to a business that cannot be collected and can be deducted as an operating expense.

Balance Sheet. A statement listing a business's assets (what it owns), liabilities (what it owes), and net worth (the difference between the assets and liabilities). A balance sheet shows the financial position of a business at a given point in time.

Bankruptcy. A federal law providing a way for individuals or businesses to wipe out certain debts. There are different kinds of bankruptcy. A defunct business will likely file Chapter 7 bankruptcy, wherein its assets are distributed to creditors and any remaining debts are canceled. Chapters 11 and 13 bankruptcy allow businesses and individuals to repay debts over time while remaining in operation.

Basis (Tax Basis). The tax cost of an asset. Basis is adjusted upward by improvements or downward by depreciation. Basis is used to calculate depreciation and amortization deductions and to determine gain or loss on the sale or other disposition of an asset. Put simply, basis is

normally your purchase price for an item. *See* Capital Expenditure.

Bookkeeper. Someone who records financial data in the accounting records of a business and maintains the accounting system.

Books (Business). The collection of records of financial accounting of business activity kept on paper or in a computer file.

Business. An activity carried on with the intent to make a profit.

Business License. A permit issued by a local or state governmental agency allowing a business to operate. Most enterprises are required to have one or more licenses and must go through an application process and pay a fee for this privilege. A business license is not issued by the IRS or required to qualify as a taxable entity, however.

Calendar Year Accounting Period. A 12-month period for tax purposes that ends on December 31. *See also* Fiscal Year Accounting Period.

Capital. The investment in a business by its owners. *See also* Equity.

Capital Asset. Any type of property that has a useful life of more than one year, such as a computer or truck used for business.

Capital Expenditure. Cost to acquire an asset or make improvements to an asset which increases its value or adds to its useful life. *See also* Basis.

Capital Gain or Loss. A gain or loss from the sale or exchange of a capital asset—the difference between the amount realized on the sale or exchange of an asset and the amount of the adjusted basis of the asset.

Capitalized Expenditure. An expenditure for a capital asset that must be tax deducted over more than one year, as opposed to an ordinary expense. For example, repairing a broken window is an ordinary expense, but remodeling a storefront is an expense that must be capitalized.

Carryovers. Tax rules often limit the ability of a taxpayer to use deductions, losses, and credits

in the year incurred. The excess of a tax deduction, loss, or credit over what can be used in a current year is called a carryover, and may be taken in past or future years.

Cash Method of Accounting. Accounting for income by reporting it when actually or constructively received, and reporting expenses when paid. Also called cash basis method. *See also* Accrual Method; Constructive Receipt (of Income).

Certified Public Accountant (CPA). The most highly qualified of all accounting professionals. CPAs are licensed by the state and must meet rigorous educational and testing requirements.

Chart of Accounts. A complete list of a business's expense and income accounts by category. It includes all accounts that appear on the business's balance sheet, as well as the accounts that track particular kinds of expenses or income.

Cohan Rule. A federal court decision allowing taxpayers to use reasonable approximations of expenses when records are missing. The *Cohan* rule has its limitations and cannot be used to approximate travel and entertainment business expenses.

Constructive Receipt (of Income). Income not physically received but treated by the tax code as if it had been because it is accessible to the recipient without qualification. *See also* Cash Method.

Corporation. A state-registered business that is owned by shareholders. The tax code considers all corporations to be taxable entities, called C corporations, unless the shareholders have elected S status. *See* S Corporation.

Cost of Goods Sold (CGS). The amount paid by a business for inventory that is sold during a tax year. The formula for determining the CGS is: the beginning inventory plus the cost of purchases during the period, minus the ending inventory at the end of the period. Also called cost of sales.

Credit. *See* Tax Credit.

Death Benefit. A fringe benefit payment that is tax deductible to a C corporation, within dollar limitations, and not taxable to the recipient.

Deductible Business Expense. An expenditure that is ordinary and necessary and deductible from the business's gross receipts.

Deduction. An expense that the IRC allows an individual or business to subtract from its gross income to determine its taxable income. Example: the cost of this book if you are in business.

Deferred Compensation. Earned income of an individual that is put into a retirement plan and not taxed until withdrawn, such as a 401(k) plan.

Deficiency (Tax). Any difference found by the IRS between a taxpayer's reported tax liability and the amount of tax the IRS says that the taxpayer should have reported.

Dependent Care Plan. A fringe benefit (an amount) that can be given tax free to eligible employees of a business to care for their dependents and is deductible to the business, within limitations.

Depreciable Asset. Property used in a business with a useful life of at least one year and deductible over a period set by the IRC. Includes buildings, vehicles, and equipment used in a business, but not land, which is never depreciable.

Depreciable Basis. *See* Basis.

Depreciation. An annual tax deduction allowed for the loss of value of an asset due to wear over a period of years, such as a business auto or real estate improvement. The amount of the deduction each year depends on which of the depreciation methods allowed in the tax code for the kind of asset is applied.

Disallowance (Audit). An IRS finding at audit that a taxpayer was not entitled to a deduction or other tax benefit claimed on a tax return.

Dividend. Corporation earnings distributed to shareholders. *See also* Unearned Income.

Documentation. Any tangible proof that substantiates an item on a tax return, such as a canceled check for an expense claimed as a deduction.

Double-Entry System. A system of accounting that records each business transaction twice (once as a debit and once as a credit), and is more accurate than single-entry accounting.

Earned Income. Compensation for services rendered, such as wages, commissions, and tips. *See also* Unearned Income.

Education Benefits. Financial assistance to an employee that is tax-free to the recipient and a tax deductible expense to the business, within tax code limitations.

Employee. A worker under the direction or control of an employer and subject to payroll tax code rules. *See also* Independent Contractor.

Employer Identification Number (EIN). A 13-digit number assigned to a business by the IRS, upon application. *See also* Taxpayer Identification Number.

Employment Taxes. *See* Payroll Taxes.

Enrolled Agent (EA). A type of tax professional permitted to practice before the IRS along with attorneys and CPAs. An EA must demonstrate competence by passing an IRS test or have at least five years' work experience with the IRS.

Entry. A transaction recorded in the accounting records of a business.

Equity. The net worth of a business, equal to its assets minus its liabilities. Also refers to an owner's investment in the business.

ERISA (Employees' Retirement Income Security Act). A federal law that governs employee benefits, such as pension and retirement plans.

Estate Tax. A tax imposed by the federal government (and many states) on the net value of a decedent's assets.

Estimated Taxes (ES). Quarterly tax payments to the IRS by self-employed individuals for their anticipated income tax liability for the year. If payments are not made on time, a penalty may be imposed by the IRS.

Examination. *See* Audit.

Examination Report. The findings issued by an IRS auditor after an audit is concluded.

Excise Tax (Federal). A tax, usually at a flat rate, imposed on some businesses for a certain type of transaction, manufacturing, production, or consumption.

Exemption. An annual deduction amount allowed to a taxpayer and each of his or her dependents on the taxpayer's Form 1040 tax return.

Expense. A business cost. *See also* Deductible Business Expense.

Fair Market Value. The price a buyer and seller of any kind of property agree on as just, when neither is under any compulsion to buy or sell.

Family Limited Partnership. A business that is a limited partnership of only related members. It can be used to shift present business income and to transfer a business to succeeding generations at a tax savings. *See also* Limited Partnership.

Federal Insurance Contributions Act (FICA). Social Security and Medicare taxes, which are generally applicable to everyone with earned income. Employers and employees split the tax; self-employed pay the entire tax. *See also* Payroll Taxes; Self-Employment (SE) Tax.

Federal Tax Deposits (FTD). An employer is required to place payroll taxes withheld from employees, as well as employer contributions for Social Security and Medicare taxes, in a federal depository (bank).

File (a Return). To mail or electronically transmit to the IRS in a specified format the taxpayer's information about income and tax liability.

Fiscal Year Accounting Period. A 12-month period ending on the last day of any month except December. *See also* Calendar Year Accounting Period.

Fixed Asset. A business asset with a useful life of more than one year as determined by the Internal Revenue Code. *See also* Depreciable Asset.

401(k) Plan. A tax-advantaged deferred compensation arrangement in which a portion of a worker's pay is withheld by the business and invested in a plan where it earns income tax-deferred until withdrawn.

Fraud. *See* Tax Fraud.

Freelancer. *See* Independent Contractor.

Fringe Benefit. Any tax-advantaged benefit allowed a business owner or employee. A fringe benefit may be partially or totally tax free to the recipient and tax deductible to the business. Prime examples are health and retirement plans.

FUTA (Federal Unemployment Tax Act). An annually paid tax on all employers for unemployment insurance.

General Journal. A book or computer file where all financial transactions of a business are recorded. Also called general ledger.

Goodwill. The excess value of a going business, over and above the worth of all of its other assets.

Gross Income. Money, goods, and property received from all sources required to be reported on a tax return, before subtracting any adjustments, exemptions, or deductions allowed by law. Also called gross receipts in business.

Group Life Insurance Benefit. *See* Fringe Benefit.

Hobby Loss Provision (IRC § 183). An IRC limitation on tax deducting losses or expenses of any activity that is not carried on with a profit motive.

Home Office. The portion of a home in which the taxpayer carries on a business activity. If the home office is used regularly and exclusively for business and meets other tax code tests, then a deduction—up to the amount of business income—may be taken for the business portion of the home, for depreciation on the structure, or for rent paid.

Improvements. Additions to or alterations of a capital asset, which either increase its value

or extend its useful life. *See also* Capitalized Expenditure.

Incentive Stock Option (ISO). An option to purchase corporate stock, granted to an employee. Generally not taxed until the stock is sold.

Income. All money and other things of value received, except items specifically exempted by the tax code. *See also* Gross Income.

Income Statement. *See* Profit and Loss Statement.

Income Taxes. Federal and state taxes, levied on an individual or corporation for earned (such as wages) and unearned (such as dividends) income.

Independent Contractor. A self-employed individual whose work hours and methods are not controlled by anyone else; not subject to payroll tax rules. *See also* Employee; Proprietorship.

Individual Retirement Account (IRA). A retirement plan established by an individual allowing annual contributions of earned income, and tax deferred accumulation of income in the account. Contributions may or may not be tax deductible, depending on the individual's annual income, and whether the IRA is a Roth IRA.

Information Return (Income). A report filed with the IRS by a business showing amounts paid to a taxpayer, such as Form W-2 (wages) or Form 1099 (independent contractor and other types of income). No tax is due with an information return, but there are penalties for not filing one or for filing late.

Installment Payment Agreement (IA). An IRS monthly payment plan for unpaid federal taxes.

Installment Sale. The purchaser of an asset pays the seller over several years, allowing the tax liability on any gain to be spread over the same period of time instead of all in the year of the sale.

Intangible Property. Assets that consist of rights rather than something material. For example, the accounts receivable of a business is an

intangible asset because it is the right to receive payment rather than the money itself. The funds, when received, become a tangible asset.

Intent to Levy. A notice to a delinquent taxpayer that the IRS intends to seize (levy) the taxpayer's property to satisfy a tax obligation. This warning is usually issued at least 30 days prior to any confiscation. Intent to levy notices don't necessarily mean the IRS will actually make any seizures. *See* Levy.

Interest. Cost of borrowing or owing money, usually a tax deductible business expense. The IRS adds interest to overdue tax bills.

Internal Revenue Code (IRC). The tax laws of the United States as enacted by Congress. Also called the tax code or simply the code.

Internal Revenue Service (IRS). The branch of the U.S. Treasury Department that administers the federal tax law. Also called the Service by tax professionals, and worse by most other folks.

Inventory. Goods a business has on hand for sale to customers, and raw materials that will become part of merchandise.

Investment. Money spent to acquire an asset, such as the purchase of a partnership interest or stock in a corporation.

IRC § 179. A tax rule allowing a deduction for the purchase of certain trade or business property in the year the property is placed in service.

IRC § 1244 Stock. Corporation stock issued under the rules of IRC § 1244, which allow an ordinary tax loss to be claimed, within tax code limitations, by the shareholder.

Itemized Deductions. Expenses allowed by the tax code to be subtracted from your tax-reported income, such as medical expenses, mortgage interest, and charitable donations.

Joint Tax Return. A combined income tax return filed by a husband and wife. Alternatively, a spouse may file a separate tax return.

Journal. *See* General Journal.

Keogh Plan. A type of retirement plan for self-employed people, allowing part of their

earnings to be taken from their income to accumulate tax-deferred in an investment account until withdrawn.

Lease. A rental agreement for the use of property, such as buildings or equipment. Lease payments are deductible if the property is used in a trade or business.

Levy. An IRS seizure of property or wages from an individual or business to satisfy a delinquent tax debt. *See* Intent to Levy.

Liability (Business). Money owed by a business to others, such as a mortgage debt, payroll taxes, or an Account Payable.

Lien. *See* Tax Lien.

Limited Liability Company (LLC). A form of business that is taxed much like a partnership and shields its owners from liability for business debts, like a corporation.

Limited Partnership (LP). An entity consisting of at least one general partner with unlimited liability for business debts, and one or more limited partners whose liability is limited to their investment in the partnership. *See also* Limited Liability Company.

Listed Property. Certain types of depreciable assets used in a business on which the IRC may require special record keeping, such as cellular phones, home-based computers, boats, airplanes, and personal cars used for business.

Loss (Operating). An excess of a business's expenses over its income in a given period of time, usually a tax year.

Loss Carryover. *See* Carryovers; Loss (Operating).

MACRS (Modified Accelerated Cost Recovery System). An IRC-established method for rapidly claiming depreciation tax deductions.

Manual Accounting System. An accounting system maintained by hand, using paper.

Marginal Tax Rate. The income tax rate at which an individual's next dollar of income is taxed.

Medical Expense Reimbursement Benefit. *See* Fringe Benefits.

Medicare Tax. A portion of the Social Security tax of 2.9% on all of an individual's net earned income. *See* Self-Employment (SE) Tax; Payroll Taxes.

Mileage Log. A record of miles traveled in a vehicle used for business.

Negative Income. *See* Loss (Operating).

Net Income. Gross income less expenses; a business's profit, usually determined annually.

Net Loss. *See* Loss (Operating); Net Operating Loss.

Net Operating Loss (NOL). An annual net loss from a business operation. An NOL may be used to offset income of unincorporated business owners from other sources in the year of the loss. An NOL may be carried back two years to reduce tax liabilities or secure refunds of taxes. *See* Carryovers.

Net Worth. *See* Equity.

Ninety-Day Letter. Official notice from the IRS that a taxpayer has 90 days to contest an IRS audit by filing a petition to the United States Tax Court, or else the decision will become final.

Notice of Deficiency. *See* Ninety-Day Letter.

Notice of Tax Lien. *See* Tax Lien Notice.

Offer in Compromise. A formal written proposal to the IRS to settle a tax debt for less than the amount the IRS claims is owed.

Operating Expense. A normal out-of-pocket cost incurred in a business operation, as opposed to depreciation or amortization expense. Examples are rent, wages, and supplies.

Ordinary Income. Any earned income, such as wages, and not from the sale of a capital asset or from an investment. *See* Unearned Income; Capital Gain or Loss.

Partnership. A business of two or more individuals (or other entities) which passes its income or losses to its individual partners. A partnership does not pay taxes but is required to file an annual tax return.

Payroll Taxes. The federal income taxes withheld by employers and FICA contributions—including both Social Security and Medicare—that must be deposited to an IRS account for their employees. States may also impose payroll taxes. *See also* Independent Contractor.

Penalties (Tax). Fines imposed by the IRS on taxpayers who disobey tax rules.

Personal Asset. Property owned by an individual, which may also be used in a business.

Personal Income Tax. Annual tax based on an individual's taxable income, less adjustments, deductions, and exemptions allowed by the tax code.

Personal Property. Anything of value that is not real estate—such as cash, equipment, or vehicles. *See also* Real Property.

Posting. The act of entering financial transactions into an accounting record, or transferring data from a book of original entry to a ledger.

Profit and Loss Statement (Income Statement). A writing showing a business's gross income, and subtracting from that figure its expenses and the cost of goods sold to reveal a net profit or loss for a specific period.

Profit Motive. An intention to make a profit is imposed by the IRC on anyone going into business. *See also* Hobby Loss Provision.

Proprietorship. A business owned by an individual that is not a partnership, an LLC, a corporation, or any other type of legal tax entity.

Prorate. To allocate or split one figure between two items, such as prorating business and personal use of an asset.

Protest. A request to appeal a decision within the IRS. *See* Appeal.

Qualified Personal Service Corporation (QPSC).

A tax-code-qualified incorporated business composed of one or more members of a specific profession. It must file an annual tax return.

Qualified Plan. A tax-code-qualified and IRS-approved employee benefit plan, usually a pension or profit-sharing plan. *See* ERISA.

Qualified Small Business Stock. Certain small business corporation shares held for more than five years, with any gain upon sale being taxed at 50% of the normal rate.

Real Property. Real estate, consisting of land and structures built on it. *See also* Personal Property.

Record Keeping. The listing of financial transactions for a business. *See also* Records.

Records. Tangible evidence, usually in writing, of the income, expenses, and financial transactions of a business or individual.

Regulations (Regs). Treasury Department interpretations of selected Internal Revenue Code provisions.

Representative. A tax professional who is permitted to represent a taxpayer before the IRS. The representative must be a Certified Public Accountant, Tax Attorney, or Enrolled Agent.

Research and Development Expenses. Certain tax-deductible costs for developing new products or services.

Retained Earnings. The accumulated and undistributed profits of a corporation. Retained earnings are subject to tax.

Retirement Plan. Typically, a tax-advantaged arrangement under which annual deposits are made to an account for an owner's or employee's benefit on retirement. Income tax on the accumulated funds is deferred until the year in which they are withdrawn.

Revenue Agent. An IRS examiner who performs audits of taxpayers or business entities in the field, meaning outside IRS offices. *See* Tax Auditor.

Revenue Officer. Certain IRS tax collectors.

S Corporation (Sub-Chapter S Corporation). A state-incorporated business that elects special tax treatment to pass its income or loss through to shareholders instead of being directly taxed on its income. *See* Corporation; Partnership.

Sales Tax. A state (not federal) tax imposed on sales of retail products based on a percentage of the price.

Schedule. A form on which taxpayers report details about an item, usually income or expense, which is attached to the main tax return.

Section 179. *See* IRC § 179.

Section 1231 Assets. Property used in a trade or business that is depreciable and for which gains, when sold, are taxed at capital gains rates, while losses are treated as ordinary losses.

Seizure (IRS). *See* Levy.

Self-Employed. A person who works in his or her own business, either full or part time.

Self-Employment (SE) Tax. Social Security and Medicare taxes on net self-employment income. The SE tax is reported on the individual's income tax return. The amount of tax is subject to annual revision under federal law.

Service Business. Any enterprise that derives income primarily from providing personal services, rather than goods. Examples: consultants, physicians, and accountants.

Shareholder (Stockholder). An investor in a corporation whose ownership is represented by a stock certificate. A shareholder may or may not be an officer or employee of the corporation.

Sideline Business. A for-profit activity carried on in addition to an individual's full-time employment or principal trade or business.

Simplified Employee Pension (SEP, SIMPLE, or SEP-IRA). A pension plan allowing self-employed business owners and their employees to deduct and put part of their earnings into a retirement account to accumulate tax-deferred until withdrawn. *See also* Individual Retirement Account (IRA); Keogh Plan.

Single-Entry Accounting. A system of tracking business income and expenses that requires only one recording of each financial transaction. *See also* Double-Entry System.

Sole Proprietorship. *See* Proprietorship.

Standard Deduction. An annual tax deduction granted to each taxpayer who does not choose to itemize deductions. The amount depends on your age, your filing status, and whether you can be claimed as a dependent on someone else's tax return.

Standard Mileage Rate. A method for deducting automobile expenses based on the mileage driven for business. This is an alternative to claiming actual operating and depreciation expenses.

Statutes of Limitation (Tax). Varying limits imposed by Congress on assessing and collecting taxes, charging tax crimes, and claiming tax refunds.

Stock Dividend. *See* Dividend.

Straight-Line Depreciation. Depreciating assets of a business by deducting their cost in equal annual amounts. The period of time is specified by the tax code for different categories of property, typically from three to 39 years.

Summons. A legally enforceable order issued by the IRS compelling an individual taxpayer or business to provide information, usually financial records.

Tangible Personal Property (Asset). Anything of value that is physically movable, such as equipment, vehicles, machinery, and fixtures not attached to a building or land.

Tax. Required payment of money to governments to provide public goods and services.

Tax Attorney. A lawyer who specializes in tax-related legal work and has a special degree (LL.M.–Tax) or certification from a state bar association.

Tax Auditor (Examiner). An IRS employee who determines the correctness of tax returns filed by individual taxpayers and business entities at the IRS offices. *See also* Revenue Agent; Audit.

Tax Basis. *See* Basis.

Tax Bracket. The percentage rate at which an individual's or taxable entity's last dollar of income is taxed. *See also* Marginal Tax Rate.

Tax Code. *See* Internal Revenue Code (IRC).

Tax Court (U.S.). A federal court where an individual or business taxpayer can contest an IRS action, typically a tax assessment, without first paying the taxes claimed due.

Tax Credit. An amount the tax code allows you to subtract from your tax bill.

Tax Deduction. *See* Deduction.

Tax-Exempt Income. Receipt of income that is specifically made exempt from taxation by Congress. Example: municipal bond interest.

Tax Fraud. Conduct meant to deceive the government or cheat in the assessment or payment of any tax liability. Tax fraud can be punished by both civil penalties (money) and criminal ones (imprisonment and fines), by both the IRS and tax agencies.

Tax Law. The Internal Revenue Code (IRC) and the decisions of federal courts interpreting it.

Tax Lien. Whenever you owe money to the IRS and don't pay after the IRS has demanded payment, the IRS has a claim against your property. This is called a tax lien, which arises automatically by operation of law. The IRS has the right to inform the public that you are subject to a tax lien. This is done by recording a Notice of Federal Tax Lien at the county recorder's office or with your secretary of state's office. A tax lien allows the IRS to seize (levy on) your property to satisfy your tax debt. Also, most state tax agencies are given lien powers for state taxes due. *See also* Levy.

Tax Lien Notice (Federal). An IRS announcement of a tax debt placed in the public records where the debtor resides or the business is located.

Tax Loss Carryover. *See* Carryovers.

Tax Pro. An expert working privately in the tax field. *See* Certified Public Accountant; Enrolled Agent; Tax Attorney.

Tax Rate. A percentage rate at which income is taxed, which may be fixed or may change at different income levels, and is set by Congress.

Tax Withholding. *See* Withholding.

Taxable Income. An individual's or entity's gross income minus all allowable deductions, adjustments, and exemptions. Tax liability is figured on the net result.

Taxpayer Bill of Rights. Federal tax laws restricting IRS conduct and establishing taxpayer rights in dealing with the IRS. Highlights of this law are contained in IRS Publication 1.

Taxpayer Identification Number (TIN). An IRS-assigned number used for computer tracking of tax accounts. For sole proprietors without employees, it is their Social Security number. For other business entities the TIN is a separate 13-digit number called an Employer Identification Number. *See* Employer Identification Number.

Three-of-Five Test. A rebuttable IRS presumption that a business venture that doesn't make a profit in three out of five consecutive years of operation is a not a business for tax purposes. *See also* Profit Motive; Hobby Loss Provision.

Transaction. A financial event in the operation of a business. Examples: paying an expense, making a deposit, or receiving payment for selling a service.

Trust Fund Recovery Penalty. Also known as the 100% penalty. A tax code procedure

for shifting payroll tax obligations from a business (usually an insolvent corporation) to individuals associated with the business operation.

Unearned Income. Income from investments, such as interest, dividends, and capital gains or any other income that isn't compensation for services. *See* Earned Income; Dividend.

Useful Life. The period of months or years the tax code directs to be used to write off a business asset.

Wages. Compensation paid to employees of a business. *See also* Payroll Taxes; Independent Contractor; W-2 Form.

Withholding. Money held back by an employer from an employee's wages to pay Social Security, Medicare, and income taxes. Withholding is required by most states as well.

Write-Off. A tax deductible expense, usually referring to depreciating or taking a Section 179 expense for an asset used in business. *See* Depreciation.

W-2 Form. Wages paid to employees are reported by employers on this annual form filed with the Social Security Administration. A copy must be given to each employee by the end of January each year.



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- 334 Tax Guide for Small Business
- 509 Tax Calendars
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- 910 Guide to Free Tax Services

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- 15-A Employer's Supplemental Tax Guide
- 51 Agricultural Employer's Tax Guide (Circular A)
- 80 Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)

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564	Mutual Fund Distributions	926	Household Employers
570	Tax Guide for Individuals With Income From U.S. Possessions	929	Tax Rules for Children and Dependents
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901	U.S. Tax Treaties		
907	Tax Highlights for Persons with Disabilities		
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911	Direct Sellers		
915	Social Security and Equivalent Railroad Retirement Benefits		
917	Business Use of a Car		
919	How Do I Adjust My Tax Withholding?		

Spanish Language Publications

1SP	Derechos del Contribuyente
556SP	Revisión de las Declaraciones de Impuesto, Derecho de Apelación y Reclamaciones de Reembolsos
579SP	Cómo Preparar la Declaración de Impuesto Federal
594SP	El Proceso de Cobro del IRS
596SP	Crédito por Ingreso del Trabajo
850	English–Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

Forms Checklist and Due Dates

Some of the federal taxes for which a sole proprietor, corporation, LLC, or partnership may be liable are listed below. If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next day that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

You May Be Liable For	If You Are	Use Form	Due on or Before
Income tax	Sole proprietor	Schedule C or C-EZ (Form 1040)	Same day as Form 1040
	Individual who is a partner, S corporation shareholder, or LLC member	Schedule C or E (Form 1040)	15th day of 4th month after end of tax year
	Corporation	1120 or 1120-A	15th day of 3rd month after end of tax year
	S corporation	1120S	15th day of 3rd month after end of tax year
Self-employment tax	Sole proprietor, corporation, S corporation, partnership, or LLC member	Schedule SE (Form 1040)	Same day as Form 1040
Estimated tax	Sole proprietor, or individual who is a partner, LLC member, or S corporation shareholder	1040-ES	15th day of 4th, 6th, and 9th month of tax year, and 15th day of 1st month after the end of tax year
	Corporation	1120-W	15th day of 4th, 6th, 9th, and 12th month of tax year
Annual return of income	Partnership or LLC	1065 (one-person LLC reports on Schedule C (Form 1040))	15th day of 4th month after end of tax year
Social Security and Medicare taxes (FICA taxes) and the withholding of income tax	Sole proprietor, corporation, S corporation, partnership, or LLC member	941	4-30, 7-31, 10-31, and 1-31
		8109 (to make deposits)	See IRS Publication 334, Chapter 34
Providing information on Social Security and Medicare taxes (FICA taxes) and the withholding of income tax	Sole proprietor, corporation, S corporation, partnership, or LLC member	W-2 (to employee)	1-31
		W-2 and W-3 (to the Social Security Administration)	Last day of February

Forms Checklist and Due Dates (continued)

You May Be Liable For	If You Are	Use Form	Due on or Before
Federal unemployment (FUTA) tax	Sole proprietor, corporation, S corporation, partnership, or LLC member	940–EZ or 940	1-31
		8109 (to make deposits)	4-30, 7-31, 10-31, and 1-31, but only if the liability for unpaid tax is more than \$100
Information returns for payments to nonemployees and transaction with other persons	Sole proprietor, corporation, S corporation, partnership, or LLC member	Forms 1099, 1098 See IRS Publication 334, Chapter 36	Form 1099—to the recipient by 1-31, and to the IRS by 2-28. See also IRS Publication 334, Chapter 34
Excise taxes		See IRS Publication 334, Chapter 37	See the instructions to the forms

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- **Where's My Refund**— Your refund status anytime from anywhere
- **Free Tax Return Preparation**— Free tax assistance and preparation
- **Recent Tax Changes** — Highlights on newly-enacted tax law
- **Innocent Spouses** — Tax Information for Innocent Spouses
- **Disaster Tax Relief** — Tax relief provisions for disaster situations
- **Identity Theft and Your Tax Records** — Safeguard your identity and tax records
- **Online Payment Agreement (OPA) Application** — Online agreements

- **Applying for Offers in Compromise** — Information on Offers in Compromise

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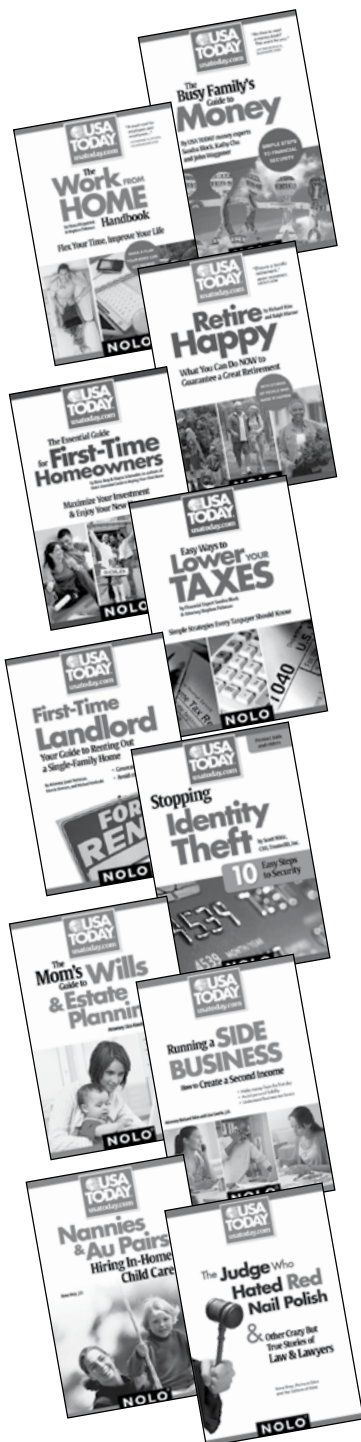
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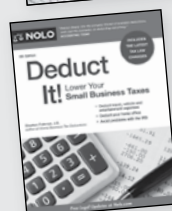
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